

Role and impact of small and medium size enterprises on
the economics development of Pakistan.

By

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EXECUTIVE SUMMARY

In developing countries, the importance of SMEs is emphasized not only for creating jobs, but also for their particular role in industrial development. Today the need for our country is to promote this sector through efficient utilization of resources available to us. The study emphasizes on role played by Micro, small and medium-sized enterprises in low-cost employment generation, poverty alleviation, rapid industrialization and economic development. Over the past fifty years, numerous attempts have been made to promote small enterprise development in Pakistan; new governmental institutions have been created but nothing substantial has been done so far. As yet, no standard definition exists for SMEs in Pakistan and there is no overall “SME policy” arrangement for compliance with the regulatory framework. In the policy areas of finance, business operations and taxation, SME specific measures are hard to find. At the aggregate level, procedures for compliance are biased towards large-scale enterprises. This study looks at the present socio-economic situation in Pakistan, reviewing its economic growth over the past 50 years. Various strategies and policy formulation practices are described, to provide a background to the current planning climate and the problems and opportunities that will arise in the formulation of economic policy on SMEs development.

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Chapter 1: Introduction

1.1 Economic and Business Scenario of Pakistan

Pakistan's economy is based on agriculture. Agriculture contributes 25% to the GDP, employs 44% of the country's workforce and contributes substantially to export earnings. To supplement the agricultural sector and strengthen the economy of Pakistan, the government had focused on large-scale industrialization in the past. The major large scale industry includes textile, sugar, food and beverages, leather, paper and paper board, chemicals, basic metals, automobiles, etc. The objective and rationalism to support the large-scale industry was to attain self-sufficiency through import substitution, and to develop the large-scale entrepreneur since they have a higher propensity to save, thus higher propensity to invest. Hence, almost 80% of the total deposits of financial institutions were spent on financing large-scale projects. Large scale industry forms the formal sector of the economy. But, as records and experience indicates, most of these institutions have booked huge non-performing portfolios.

The economy of Pakistan has undergone a thorough restructuring process in socio economic situation at independence and at the end of the twentieth century.

Pakistan Basic Indicators, 1947-2000

	1951	2000
Population (million)	33.78	137.5
Urban (%)	17.8	35.9 (1998)
Contribution to GDP by sector (%)	1949/50	1999/2000
Agriculture	53.2	25.9
Industry	7.8	24.7
Service and Trade	39	49.4
Labor force by sector (%)	1950/51	1997/98
Agriculture	65.3	47.3
Industry	9.5	17.1
Service and Trade	25.2	35.6

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Composition of exports (%)	1951/52	1995/96
1. primary commodities	99.2	16
2. Semi-manufactures		22
3. Manufactures		63
	1951	1998
Literacy (%)	15	44
Female literacy (%)	12	29
Life expectancy (years)	43 (1960)	62
Infant mortality rate (per 1000 live births)	137	91

The composition of GDP from 1951-2000 clearly indicates a shift from agriculture to other sectors including manufacturing, trade and services. The government also planned for rapid industrialization, in order to keep pace with the growth rates of the labor force. The 1950s was a decade of virtual stagnation. The 1960s saw a successful strategy to raise investment by enhancing domestic savings and foreign aid and accelerating the pace of industrialization. Economic growth was at the rate of 6.8 per cent a year. The manufacturing sector had the fastest growth, at 9.9 percent, a figure as yet unmatched by any other decade as shown in the table below. However, the focus on large-scale development projects failed to benefit the smaller enterprises and the lower-income groups of the population.

Growth rates in Pakistan (average annual growth, percentage)

	1960-69	1970-79	1980-89	1988-97
GDP	6.7	4.8	6.4	4.7
Manufacturing	9.9	5.5	8.2	4.9
Commodity-producing	6.8	3.8	6.4	4.6
Services	6.7	6.2	6.6	4.7

In the 1970s, some landmark policy measures were adopted, including the nationalization of all major industries and the financial sector, the historic devaluation of the Pakistan rupee, and the development of industries under high tariff protection and the provision of

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export subsidy. Another significant development was the formulation and implementation of labor reforms, leading to the creation of many small and medium-sized industries. The rationalization of cost structures changed the focus of industry from vertical integration to specialization. During this period, economic growth was at the rate of 4.3 percent per year.

The 1980s saw trade liberalization, the opening of a foreign exchange and payments regime and the harnessing of the private sector to become the engine of economic growth. In this decade, trade and industrial policy shifted in emphasis: from inward-looking import substitution to outward-looking export promotion. Fixed investment declined but the GDP growth rate showed an upward trend. All sectors except services and construction showed improved growth performance. The overall GDP grew at an annual rate of 6.6 percent and large-scale manufacturing at 16.6 percent a year.

Economists generally view this period as holding the key to the current problems and opportunities for development. Four factors are particularly relevant in this context.

First, the economic growth in 1980s coincided with a number of external shocks to Pakistan's economy. The migration of Pakistani workers to neighboring oil-rich countries began in the mid 1970s, escalated in this decade. Workers' remittances became the largest single source of foreign exchange earnings; in 1982-83 they peaked at over one-tenth of GDP. In addition, the Afghan war resulted in the decision of the military regime to play a frontline role; consideration financial flows from abroad followed in the form of economic and military aid.

Second, Pakistan's economy in the 1980s was inconsistently managed. Although the military government introduced tight fiscal and monetary policies at the outset, this regime was abandoned within 3 years. Since the late 1980s, the economy has been under the guardianship of international lending agencies, as a consequence of heavy borrowing in the early 1980s. Both the International Monetary Fund and the World Bank recommended liberalization, stabilization and structural adjustment programs to curb

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fiscal deficit. Their prerequisite requirement was reducing the deficit to 4 percent of GDP. The largest cuts in public expenditure have been in the development area, falling from 9.3 percent of GDP in 1981 to approximately 3.5 percent in 1996/97.

Third, the low-income groups were the main beneficiaries of the public-sector development programs. Inflation and tax increases have most affected this segment. Both salaried and low-income groups have been unable to negotiate wage increases. Repeated price rises for electricity, gas and fuel have had a deteriorating effect on the purchasing power of the poor. In a further attempt to reduce fiscal deficit, the government imposed more indirect taxes, thus adding to the burden on this group.

Finally, the policy of privatization, begun in the mid-1980s, was accelerated in 1991 by the Privatization Commission. Besides privatizing various nationalized institutions, the government also opened some sectors to private-sector investment. The liberalization of the financial sector resulted in the growth of commercial banks and leasing companies. Competition stepped up in the financial sector, struggling to discover niche markets that would lead to broader credit base. This markedly assisted capital accumulation in small and medium-sized industries.

With the prevailing economic conditions, the government had to look at other alternatives to revive the economy. The emphasis therefore shifted from import substitution to export oriented products and value addition. Learning from the significant contribution of small and medium enterprises in the GDP in the developed countries, and understanding their contribution in the economy of Pakistan especially in the export sectors, the government has now focused on the development of small and medium enterprises. This in turn will also assist in poverty alleviation, a social problem for Pakistan.

1.2 SMEs _ the Informal Sector

In Pakistan, SMEs forms the informal sector of the economy. The term “informal sector” refers to small-scale units, producing and distributing goods. Most enterprise in the small-scale sector exists as independent individuals or family operations where authority

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of managing the business lies with the owners. Thus the management structure of SMEs varies from a simple one-man show to the collective management by shareholders. They operate with very little capital and low level of technology and skills. The turnover of employees is high as the enterprise itself is highly unstable. They do not have access to organized markets, credit institutions and to formal education and training institutions. The level of educate and intellectual people is so low that they do not have the know how of procedures in order to have access to long term financing.

SMEs are a very heterogeneous group in terms of industrial/services/agriculture sector, size, location, number of employees and customer profile. They include a wide variety of firms e.g. textile sector, leather sector, automobile vendor sector, fisheries sector etc. Their owners may or may not be resourceful. Some are dynamic innovative and growth oriented while others are traditional enterprises that draw satisfaction in remaining small. The SMEs can be defined in terms of asset size and/or number of employees.

1.3 Objectives for SMEs

The government's objectives may be summarized as to:

- Focus on SMEs to provide low cost employment opportunities, boost exports and reduce poverty;
- Establishing a more efficient management, with appropriate technology, stable financial position, proper information channels, improved human resource and working environment.

1.4 Importance of SMEs

It has been noticed, that whether it is a developed economy like the USA, Japan, & Germany, or the developing economy like Thailand and Malaysia, small and medium enterprises (SMEs) form the backbone of their economy. A dynamic and vibrant SME sector plays a key role in the successful economic growth of these countries.

An effective SME sector helps to achieve many socioeconomic objectives of a country:

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- It provides low cost employment since the unit cost of persons employed is lower for SMEs than the large-size units;
- Assists in regional and local development since SMEs accelerate rural industrialization by linking it with the more organized sector;
- Converts the raw material within the country into semi-finished items and later pass it on to the LSEs that have capital, skill and equipment to process these into finished goods;
- Contributes significantly to export revenues because of the low-cost labor intensive nature of products.
- Have a positive effect on the trade balance since SMEs generally use indigenous resources reducing dependence on imported machinery, technology and raw material;
- Are well placed to meet the demands of consumers in local and regional markets as they scatter throughout the country producing differentiated products at low costs. They satisfy end users more than the branded products of LSEs and the multinational companies;
- Provide rural women an opportunity for income generation and personal growth since they can work at home. This helps to achieve fair and equitable distribution of wealth by creating nationwide non-discriminatory job opportunities;
- Assists in fostering a self-help and entrepreneurial culture by bringing together skills and capital through various lending and skill enhancement schemes;
- Attracts direct foreign investment since multinationals and big conglomerates have started to outsource from countries with strong SME sectors. The low labor cost makes production of semi-finished goods very economical for large concerns operating in international markets.

Considering these advantages, almost all countries in the world aim at supporting and strengthening their SMEs. However, SMEs still need to overcome the economic and competitive disadvantages that they face due to their small size.

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1.5 Definition of SMEs in Pakistan

There are different ways in which the informal sector was defined. In some cases, it is defined it as, a production unit which fulfils one or more of the below eight conditions comes under the informal sector or SMEs:

- Employs no more than 10 people
- Avoids social regulation
- Does not operate at fixed hours
- Employs workers from the household of the head of the enterprises
- Has an inherent nature or occupies temporary premises
- Does not use electrical or mechanical energy
- Does not use credit from formal institutions and
- Employs workers with fewer than six years of schooling

Some individuals categorize informal sectors activities according to the degree of complexity of accounting systems: enterprises with no accounting systems; those with a rudimentary system;

SMEDA defines SMEs as:

1. Micro Enterprise
 - a. Less than 10 people
 - b. Productive Assets limit of Rs. 2.0 million
2. Small Enterprise
 - a. Between 10-35 people employed
 - b. Productive Assets limit of Rs.20 million
3. Medium Enterprise
 - a. Between 36-99 people employed
 - b. Productive assets limit of Rs. 40 million

The SME Bank defines SMEs as follows:

1. Small enterprise as any business entity having a project cost of up to Rs. 20 million.

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2. Medium enterprise as any business entity having a project cost of between Rs. 20 million.

The Punjab Directorate of Industries (PDI) defines a small unit as one with fixed assets worth Rupees 10 million or less, excluding the cost of land. The Punjab Small Industries Corporation (PSDI), sets this limit as Rupees 20 million. According to PDI, all enterprises with assets excluding land, valued between Rupees 10 million and Rupees 100 million are medium scale units. PSDI defines medium scale units as enterprises with assets excluding land valued between Rupees 20 million and Rupees 100 million. All enterprises employing less than 10 persons are classified as cottage industries while those employing over 10 persons are categorized as small or medium sized enterprises.

1.6 Problems Faced by Pakistan's SME Sector

Pakistan's economy has this amazing potential for development but sadly, we haven't been able to derive optimal benefits despite a series of efforts launched by various policy makers at different times. The impetus of all these endeavors was on the large scale industries and manufacturing concerns. High rate of failures, owing to economic slumps, institutional malpractices, political motives and damaging activities of labor unions in that sector, left the formal lending institutions with huge infected portfolios, in addition to adverse effects on the entire economy e.g. insufficient and low quality production to meet the demands of local and international markets, deficit in balance of payments and ever rising unemployment, etc.

Pakistan's SMEs are still unable to achieve their maximum potential and are in dire need of 'hand-holding' and business support services. Mostly, the small and medium entrepreneurs in Pakistan are facing following problems:

1. Non-Availability of Concrete Data on the SME sector and Pakistan's Economy

- The above creates problems for the institutions dealing with the SME sector, since financial statements and accounts of many SMEs are non-existent.

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Financial appraisals thus become an arduous task for the formal lending organizations and banks. Thus SMEs have always been termed as non-bankable and risky.

- SMEs still lack a uniform and clear definition, making it difficult for various institutions to form uniform policies and devise standardized procedures to deal with this sector.
- This lack of information is in itself a problem for the SMEs since the entrepreneurs can not find feasibilities on different businesses and sectors of the economy. The available secondary data is inadequate and can not escort them on the path leading towards success.

2. Non-Conducive Regulatory and Legislative Frameworks

- Although, the GoP is looking into the above, still Pakistan's small and medium entrepreneurs have to go through a lot to get their businesses registered, deal with the tax authorities, meet other documentation requirements and so on and so forth.
- Similarly SBP has to review and revise the set of Prudential Regulations for this sector, in order for the institutions to be able to provide financial assistance on easy terms and conditions.

3. Resistance to Change

Due to the above, back dated technology, minimal use of latest production and designing techniques and several other factors, our entrepreneurs don't think about graduating from small to medium and then to large. Our economy needs a conducive business environment and an entrepreneurial culture for the change to take place. Educational institutions, GoP and other private sector role players need to make sincere contributions, if we are to compete with the international market.

4. Financing GAP

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- Only 14% of Pakistan's SMEs approach the formal lending sector for financial assistance.
- SMEs perceive that high risks and high costs are associated with Bank's financing services. There is lack of accurate information on Banks and borrowers alike.
- SMEs are short of sound collateral and abilities to present bankable business plans.

5. Inadequate Business Support Services Providers

Unless our entrepreneur is provided with effective hand-holding, revenue and income sustainability will remain an issue for most of the enterprises. The SMEs today need support services in the field of accounting, marketing, ecommerce, product designing, pricing, human resource development etc. The efforts of SMEDA and SME Bank need to be supplemented by additional BSS providers.

6. Human Resource, Raw Material and Technology

Shortage of skilled staff causes delays in production and affects quality of output & sales. High price and unsatisfactory quality of raw material is a matter of great concern for those belonging to the manufacturing sector. The entrepreneurs are also interested in adopting new technologies and training manpower, but lack the resources, technical and training assistance. Lack of all these has led SMEs towards low productivity since the sector contributes only 30% towards value addition.

7. Marketing Issues

- Small entrepreneurs supplying to the domestic markets face issues like bargaining on price and credit purchases. And as they become outward oriented, they need to adjust and link with international markets.
- The above are some of the major impediments that the country's SMEs and stakeholders face today in addition to ever fluctuating currency rates,

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worsening economic slump, increasing unemployment, natural calamities and the never ending list of taxes.

8. SMEs Initiation

In Pakistan there are no formal restrictions to start a new undertaking. However, license is required from the municipal authorities. Procedures are generally not transparent. The process might take a few weeks, even after supplying relevant details and payment of prescribed fees.

9. Connection to Utilities

Getting connection for power, telephone, water and gas is the next stage. The officers at each utility have their own priorities and enjoy lot of discretion. Personal visits, recommendations and sometimes engagement of certain contractors are pre-requisites for getting a connection. One is obliged to spend time, money and effort to get these facilities.

10. Lack of Information

The sponsors need authentic details about markets, prices, suppliers, customers, credit reports, machinery suppliers and prices, and so may other things. Information is not easily available and so many times it leads to faulty decisions or expenses that could be avoided. The government authorities and SMEDA are already doing some work but much more needs to be done.

11. Form of Organization

Majority of SMEs start as sole proprietorships. Bank loans in modest amounts are available if security is adequate and there is sufficient collateral. This form does not support raising of larger funds. There is need to allow limited partnerships in Pakistan on the pattern of USA.

12. Loan Finance

SME Bank, IDBP, local and foreign banks, leasing companies, etc. provide finance for fixed assets or working capital. Practices and views differ on

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collaterals, processing time, transparency, security registration, loan limits, mark-up rate, projects suitability for new entrants, venture or risk capital for new process or technology development. The creditors must bring out informative brochures to help SMEs.

13. Equity Finance

There is need for institutionalizing the equity contribution or loaning by rich persons to SMEs on standardized terms and using standard agreements. Proper framework and rules need to be developed to allow such investment. SMEDA could play a major role. Equity investment cannot jump-start private sector development, but a private sector cannot be mature without it.

14. Poor Infrastructure

SMEs are operating with very poor quality of physical infrastructure such as roads, bridges, railways, air cargo facilities, ports, drainage, power supply and proper transport. Due to this, there are delays and costs go higher.

15. Lack of Special Purpose Buildings

There are not many special-purpose buildings for housing the wholesalers, service providers, light industries, trade, packing and repacking units, etc. within municipal limits. Women may particularly benefit from locating in such buildings. SMEs could become operative with less capital and within a shorter time.

16. Difficulty in Locating Partners

At times SMEs need to add a partner or to engage an expert to enhance resources, management capability or technical expertise. Wrong choices create trouble. There should be credit bureau that provides background information and certification for suitability of such persons for a fee.

17. Machinery and Building Construction

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A new entrant often ends up with unsuitable machines, or pays more than reasonable price. Building contractors might over-charge, delay completion or violate important conditions of contract. SMEDA can help SMEs by providing details, guidelines and standardized contracts for such purposes.

18. Accounts and Filing of Returns

SMEs are obliged to maintain accounts and details as specified by the respective government departments in addition to the financial accounts. SMEs are often operating with less staff; every employee is handling many assignments that are handled by different persons in bigger corporation. SMEs find it difficult to meet the requirements of a large number of government agencies. Mistakes or non-submission on timely basis invite penalties. Formats used and procedures may be simplified.

19. Payment of Different Taxes

The SMEs are required to file CED, Sales Tax, and Income Tax returns and to pay the respective amounts. In addition, there are a large number of other agencies that require payment of different fee. Failure invites penalties and threat of business closure or confiscation. Reduction in the number taxes, the agencies dealing with SMEs and returns to be filed will help SMEs a lot.

20. Refund Taxes

SMEs pay different taxes, sometime in advance; a part of some of the taxes is refunded or adjusted as per government policy. The refunds are often delayed. Textile value-added sector, an important segment of SMEs is particularly suffering due to the delays. As a result, SMEs run short of working capital that adversely affects production.

21. Recovery of Receivables

SMEs face credit risk. The buyers of goods and services might not pay on time, or simply refuse to pay on pretext of business slump or failure. The preferred route

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for this is Dispute Resolution Forum at CCI or FPCCI level. This will save time and effort. SMEs may concentrate on improving quality and competitiveness.

22. Frauds in Exports

Normally, SMEs produce quality products at competitive prices and on that basis secure export orders. However, once in a while clever importers refuse to accept the goods on flimsy grounds or get the goods but escape payment on some technicality. SMEs suffer big loss, as they are obliged to pursue legal proceedings for recovery in a foreign land. The government has to safeguard interest of SMEs.

23. Litigation with Creditors

SMEs experience ups and downs that the creditors generally do not appreciate. They start legal proceedings for loan recovery. Rescheduling facility may be provided in genuine difficult situations.

24. Law and Order

Law and order deterioration is a killer of SMEs, as delivery schedule is disrupted. Foreign buyers or quality inspectors cannot visit the factory. Export orders are shifted to other countries. The laborers face problems for commuting to the factory, often at odd hours. This increases cost of production and competitive advantage is lost. The government is urged to give more attention to this.

25. Environment Requirements

SMEs are mostly short of cash and find it difficult to install environment related equipment. The government may obtain more grant funds to make SMEs comply with environment requirements. This is essential for higher exports.

26. Financing Problems of SMEs

Problems faced by the Banks to lend to SMEs

The financial institutions face following difficulties in lending to SMEs:

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- Lack of transparency in the business operations
- Poor record keeping
- Poor operational performance
- Problems in packaging a bankable proposal
- High transactional cost
- High turn around time
- Lack of skills in the banks
- Collateral requirements
- High risk of monitoring

Problems faced by the SMEs to borrow from Banks

The SMEs generally do not borrow from banks and borrow from the informal sector mainly due to:

- Fear in becoming part of formal sector
- Fear documentation
- Limited knowledge of financing options
- Lengthy and cumbersome procedures
- High turn around time
- Collateral requirements

Chapter 2: LITERATURE REVIEW

Small Business Management (An Entrepreneurial emphasis) by Longenecker Moore Petty. The research work emphasizes on the developing a competitive advantage and selecting a market niche. It provides a more complete presentation on determining the nature and amount of asset and financing requirements for a new venture. Gives coverage of international marketing and its implication for small business. How to apply Total Quality Management in all types of business operations and how to apply capital budgeting techniques within small firms.

Effective Small Business Management by Richard M. Hodgetts and Donald F. Koratko. Their study basically provides an introduction to the world of small business and to the fundamentals of effective small business management. Special focus is given on small business in the United States. It highlights the technology revolution and its impact on small business. It lays out various opportunities for getting into small business and elaborate various methods how to develop a business plan.

Total Quality Management in Small Business by Parag Diwan. The study lays out an integrated five stage model for TQM implementation. How small and medium enterprises can obtain ISO 9000 certification and what kind of institutional support is required is the primary focus of the study.

Industrial policy in Pakistan (Apr 17 - 23, 2000) By Dr. Khawaja Amjad Saeed in business magazine Industry and Economy. The article is about a vital question that is in respect of nature and types of industrial units to be established. While the law of demand and supply determines the establishment of industrial enterprises, many keep inquiring about the directions to which industrial units should be established. Targets for a period of 3 to 5 years should be set in respect of growth of industrial sector. These targets should be properly monitored for ensuring proper implementation. The draft of proposed Industrial Policy should be released and publicly discussed by stakeholders. The input should be collected and then reflected into a national consensus before implementing the same.

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Small and Medium-Sized Enterprises and Economic Development edited by Eul Yong Park of Korea Development Institute in May 1995. The research paper discusses condition of small and medium enterprises in different countries like Australia, Canada, Korea, China, Taiwan and Japan.

Study on Innovative Small and Medium Sized Enterprises and the Creation of Employment (May 2000 - July 2001).). Prepared by: Austrian Institute for Small Business Research (IfGH) and Instituto Vasco de Estudios e Investigación (IKEI). The presentation report is produced in the frame of a research study on “innovative SMEs and the creation of Employment” on behalf of the European Commission, Directorate-General Enterprise. The results of the entire project shall together with other assignments strengthen the knowledge base of innovation performers and policies in Europe and will serve to effectively support the analysis and updating of priority topics of the new “innovation in a knowledge-driven economy”.

Policies to Support Small and Medium Size Enterprises (SMEs) for Economic Development by Ministry of Foreign Affairs of Japan. This report gives out certain recommendations for co-operatives and strengthened relationship between the two regions i.e. Asia and Latin America toward the 21st century. It highlights some common problems and certain measures are suggested to overcome the problems and it also gives a perspective towards the future.

Supporting Market Access for Pakistan’s Small and Medium Enterprise for Financial and Business Development Services. Issues and Support by the Asian Development Bank (15 January 2002) by Rainer Hartel, Asian Development Bank, South Asia Region, Governance, Finance and Trade Division, Karachi. The article tells us about the important role SMEs can play in our society. It addresses the issue and lay out certain reasons about “Why does it take so much time to change?” and usually this change is seen a very slow leap-frogging development in SMEs. We prefer to think in decades rather than in few years, especially in the economy like ours where there are very limited

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financial resources. The article elaborate the effort made by Asian Development Bank in the uplifting of SMEs in Pakistan and one good example is the SME Trade Enhancement Finance Program, or SMETEF a program launched to address the policy environment, the support of market based financial and business services, and development of service institutions for SME.

A case of Low Income Communities Faisalabad, Pakistan (April 2002) by S.M. Khtib Alam and Ejaz Ahmad from Faisalabad Development Authority. This case study is the seventh of a series of very interesting research being undertaken and produced by the team of Faisalabad Area Upgrading Project (FAUP) based on its experience of working in Faisalabad over the last seven years. The purpose of this report is to highlight some of the initiatives that have been implemented for the development of small enterprises by the project. FAUP has provided access to skill development programs and facilities that encourage the emergence of this sector for low-income communities in its project areas. The focus of this work has been first to train communities to develop vocational skills, and then support many of the women to access financial sources from commercial institutions and assist them in identifying non-government avenues for funding micro-credit initiatives. Links were developed with banks such as the First Women Bank and local NGOs in Faisalabad that were in a position to offer low risk credit.

Creating a Conducive Policy Environment for Micro, Small and Medium-Sized Enterprises in Pakistan by Small and Medium enterprises Development authority of Pakistan (SMEDA). This working paper focuses on critical importance of an enabling environment for SMEs. This report proposes that a standard SMEs definition should exist at the national level, to enhance government recognition of the importance of SMEs in Pakistan and to promote cohesiveness in the implementation and effectiveness of policies specifically targeted to the SME sector.

Trade Secrets: The Export Answer Book for Small and Medium-Sized Exporters by SMEDA. This handbook is intended to serve as a primary reference tool for SMEs and

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consultants in need of a practical, result-orientated guide to exporting. It helps exporter to understand better the terms, processes, and resources involved in exporting.

The role of small and medium enterprises in the economy By Nabil Y. Barakat of Jordan Times. The article focuses on the recent efforts by the government to enact economic reform measures to modernize and improve Jordan's economy, including the trade and investment liberalization program, were put in place to encourage foreign direct investment and to stimulate the economy. Some of the measures taken include tax relief and a privatization of public institutions. This is a step in the right direction in an attempt to increase economic activity and create jobs.

World Trade Organization (May 2003) by Alexandra Fally and Yridia Carrillo. Page 7-9 “Small and Medium-Sized Enterprises and WTO”. The article discuss certain objectives for SMEs like “improving market access”, “investment”, “trade facilitation” and “services”. It highlights certain measures and challenges to meet these objectives.

SMEs: great potential to lead economy (April 21, 2003) by Mohammad Shehzad “The News”. The article lays out various issues confronting SMEs and their possible solution. Issues include “how can the performance of SMEs be improved?”, “what has been the contribution of SMEs in Pakistan’s economy?”, “what are their predicaments?”, “to what extend the government is cognizant of these predicaments?” and “how can we make our product green and competitive?”

Chapter 3: Research Methodologies

3.1 What is Research?

Research is a systematic and planned procedure to address one or more of the things like development of new concepts, development and observation of facts that are not obvious or are not partially known, collection of information and compiling, interpreting and understanding of principles and facts to make them meaningful and useful in various contexts. For example, research here is conducted to explore the information on Small and Medium Scale Enterprises in order to make them more effective and efficient.

3.1.1 Research Problem Formulation:

The 1st step in conducting any research is to find out the research problem and objective- the reason why a research is being undertaken. Research objectives vary from research to research. Once the nature of the research problem becomes clear, the research problem needs to be translated in specific research questions.

3.1.2 Research Objectives:

It is important to determine the research objectives before carrying out and research. It helps in making the scope of the research clear with the identification of all the limitations and the boundaries.

The research objectives of carrying out this research on SMEs in Pakistan are as follows:

- To identify the problems being faced by SMEs in Pakistan
- Economic impact of SMEs on Pakistan
- Government and financial institutions role in SMEs development
- To determine the ways in which SMEs in Pakistan can be competitive to face the globalization challenges
- To improve the performance of SMEs in Pakistan

3.1.3 Limitations of the Research:

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Limitations mean the scope of a research. What is to be included and what is not to be included in carrying out a research. It is very important again to determine the correct limitations of the research in order to remain focused and avoid any difficulties that may hinder the progress of the research.

Limitations or Scope of this research on SME's in Pakistan are following:

- It studies only the Small and Medium Enterprises located in Pakistan
- It does not focus simply on a specific Small and Medium Enterprise, rather it take into account all the SMEs in general and discusses the issued faced by SMEs in Pakistan in overall.

3.1.4 Exploratory Research:

Exploratory research is conducted in order to gain background information, to define terms, to clarify problems & hypothesis and to establish research priorities. The researcher's goal is to formulate more precise questions that future research can answer.

Exploratory research frequently involves qualitative data. The techniques for gathering qualitative data are less wedded to a specific theory or research questions. Qualitative research tends to be more open to use a range of evidence and discovering new issues.

The research on SMEs in Pakistan is exploratory in a sense that it explores the idea of how SMEs in Pakistan can face globalization challenges and how can they remain competitive in the long run.

3.1.5 Types of Research:

There are different types of research depending on the nature and objectives of different researches.

3.1.6 Qualitative Research:

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Qualitative research differs from quantitative research in a sense that it does not involve numbers. It captures and discovers meaning once the researcher becomes immersed in the data.

Concepts are in the form of themes, generalizations etc. Data are in the form of words from documents, observations. The research conducted on Small and Medium Enterprises in Pakistan are qualitative as well as quantitative in a sense that it involves numbers as well as it is composed of different words from different documents.

3.1.7 Sources of Research:

Sources of Research can be classified in to Primary data research and Secondary data research. Primary research is also called the field research in which the researcher goes into the market in order to collect data that is already not available. On the other hand if the data is already available than it is called as Secondary Research.

3.1.8 Secondary Research:

The research on SME's in Pakistan is secondary because it discusses the data that is already available in different documents. That is the reason why it does not involve interviews and other primary research tools.

The data included in the research project on Small and Medium Enterprises was taken from following of the sources:

- Internet
- International Publications (Journals & Articles)
- Country research reports (i.e. Pakistan)
- Books
- Economic Surveys

Chapter 4: Analysis

4.1 Sectoral Study

4.1.1 Agriculture

Pakistan has had a sustained growth over the past two decades, which is beginning to slow down now. Investment in agriculture technology and rural infrastructures has been low; and industrial development has not been efficient enough to stimulate demand. Pakistan has therefore not exploited the full potential of its excellent agrarian resources. If properly planned and managed, even now it is possible for Pakistan to begin a synergetic relationship between agriculture and industry to stimulate export-oriented economic growth that can transform Pakistan into a middle income country within two decades.

The agricultural sector has hit the upper ceiling of its productive potential under the given structural and technological orbit. And if by well designed policy interventions, the agricultural sector was to be moved into a new, more efficient orbit of productivity. Now the industrial sector is not ready to take over the downstream processing of value-added products for international consumption.

The ultimate solution, therefore, lies in concurrent and integrated approach towards re-planning the agricultural production systems in Pakistan, ensuring the functional and economic fusion between agrarian and industrial activities of the whole production line.

The time for urgent, quick-fix solutions is over now. Some marginal gains can be made in the short run measures but a major overhaul of Pakistan's agrarian and industrial sectors has become absolutely indispensable today.

SMEDA's role is to analyze, plan and formulate financially viable project plans for private entrepreneurs. In this category SMEDA has identified three areas where such initiative is urgently required. Through a more direct approach, SMEDA has prioritized a few areas where it is working on development of complete new value chains for certain agricultural products.

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- Strategy for the Dairy market and establishment of Punjab Dairy Authority
- Strategy for Beef production specifically for export markets
- Strategy for boosting exports of vegetables and fruits has been completed till the full value chain analysis stage and now the developmental strategy is being formulated in collaboration with stake-holder

4.1.2 Textile Sector in Pakistan

➤ Textile and Global Trade

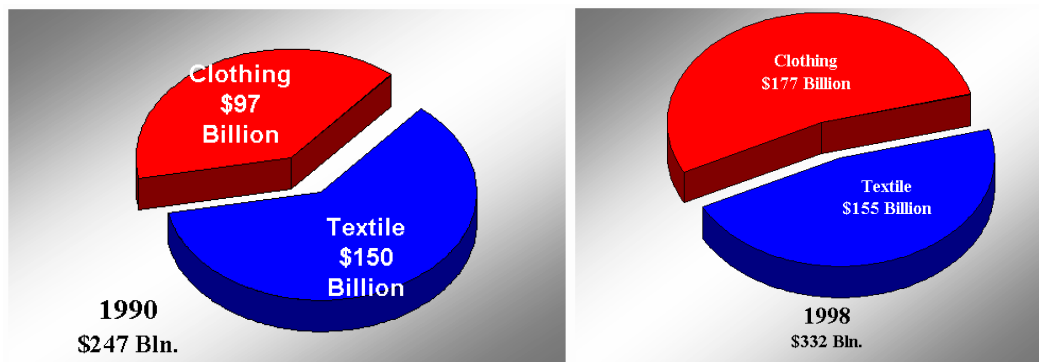
Textile trade has a significant presence in the total merchandise trade of the world. Out of total US\$ 5,465 billion, textile accounts for US\$ 333 billion or 6 % of total world merchandise trade.



➤ Textile and Clothing

Global textile and clothing trade has undergone significant changes in the last decade. Clothing trade has grown at a faster rate as compared to textile trade. The Textile trade increased from \$150 billion to \$155 billion in eight years period of 1990-98, while the clothing trade has grown from \$97 billion to \$177 billion over the same period of time.

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Textile trade indicates an obvious shift from basic textiles towards high value added products including apparel and clothing articles.

Global	Value: US \$ Million				
	1994	1995	1996	1997	1998
Cotton	5,000	7,000	7,000	6,000	4,000
Textile Yarn	24,180	28,430	28,770	30,310	25,480
Fabrics	62,520	72,860	72,740	73,660	67,000
Made Ups	10,260	12,040	12,760	13,310	12,210
Clothing	111,390	121,310	127,620	138,240	139,000
Clothing Accessories	8,180	9,380	10,200	11,340	10,940

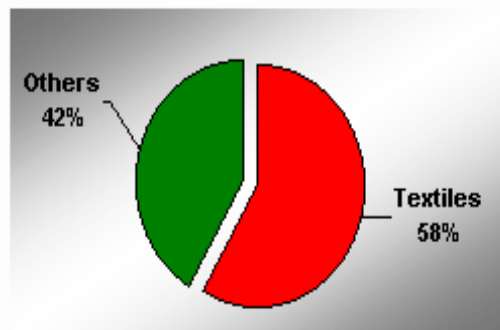
Other revealing developments that have resulted in changing world trading patterns of textile include shifting of production centers to developing countries and formation of regional trade blocks that include trade preferences for member countries.

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➤ Pakistan and Textiles

Textile & Apparel Industry is the backbone of Pakistan's economy. It contributes more than 60% to the total export earnings of the country, accounts for 46% of the total manufacturing and provides employment to 38% of the manufacturing labor force.

Total exports of Pakistan in 1997 were US\$8.4 billion out of which textiles accounted for US\$ 4.9 billion or 58%.



➤ Textile Exports of Pakistan

Total Textiles exports of Pakistan are to the tune of US\$ 4.9 billion or 1.5% of total world textiles and clothing exports.

➤ Split between Textiles & Clothing

Pakistan's export product portfolio of textiles is dominated by fabrics and yarns, whereas the high value added segment such as clothing shows a stagnant growth.

Pakistan	Value: US \$ Million				
	1994	1995	1996	1997	1998
Cotton	83	225	459	156	85

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Textile Yarn	1,424	1,648	1,672	1,458	1,111
Fabrics	1,744	1,710	2,057	1,981	1,870
Made Ups	612	726	929	957	1,081
Clothing	1,067	1,114	1,341	1,307	1,360
Clothing Accessories	140	168	162	146	117

➤ Textile Value Chain

The textile sector consists of numerous sub-sectors; each having its own distinct characteristics based on the types of inputs, technology and human resource requirements. The diversity of sub-sectors, starting from cotton and man-made fibers through garments and made-ups across the value chain requires multidimensional approach for analysis of each sub-sector.

4.1.3 Leather

Leather is the oldest form of clothing, and shelter, known to exist throughout mankind's history. Early man required protection from the hostilities of his environment. The hides and skins of the animals provided a seemingly endless supply of protection. With developments in science and technology, processes were developed to convert raw hides and skins into finished leather (tanning process) which led to use of leather as apparel articles for more specific purposes.

Leather industry is the largest industry of the world, the raw material of which is derived from a byproduct. Animals are slaughtered for getting meat, and hides and skins are obtained as a valuable byproduct.

➤ Pakistan Leather Sector

In Pakistan, Leather is the second largest sector after textile, contributing more than 7% to the export earnings. It constitutes more than 5% of the manufacturing GDP of Pakistan.

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Apart from being a major export earner, Leather sector has a huge potential for employment generation. According to an estimate, more than 200,000 workers are directly employed by the sector.

Leather industry of Pakistan has made a remarkable progress in the last twenty years. Two decades back, Pakistan used to export raw hides and skins. Gradually the industry moved towards the value-addition by exporting wet blue leather in the first phase then finished leather and finally value-added finished leather products.

Pakistani leather is considered to be one of the best quality leathers available in the international markets.

4.1.4 Fisheries in Pakistan

Pakistan has a total coastline of 1,050 km and a total fishing area of approximately 300,270 sq. kms. Pakistan's fishing grounds are termed as highly rich in marine life with a vast variety of species having commercial value. However, this potential is not reflected in the export earning from fisheries sector, which has remained stagnant around 150 million US\$, during last decade. This situation is mainly attributed to highly unorganized nature of private sector, lack of focus in Government policies and little institutional investment (in public and private sector projects) in this sector.

Pakistan's exports stood at 139 million US\$ in 1999-2000. Whereas, a rough estimate based on maximum sustainable yield figures, existing value addition, and foreign benchmarks (Indian, Bangladesh and Malaysia benchmarks for %age of landed catch exported) puts our total export potential from this sector to around 1.0 billion US \$ from existing natural resources. Including a high potential area, i.e., aquaculture, in our fisheries sector, can yield even higher export earnings from fisheries sector in Pakistan.

Pakistan's domestic consumption of fish is termed as one of the lowest in the world at 1.6 KG per person/Year. This consumption pattern coupled with increased inland fish production leaves little room for domestic marketing of marine fish. Therefore, the

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focus remains to be foreign markets mainly Europe, US, Japan and Middle Eastern countries. A brief analysis of Pakistan's export products in fisheries sectors reveals over dependence on few species with little value addition. In particular, overexploitation of shrimp species, reflected by over 66% share in export by value, poses a very strong threat to the industry as shrimp landing figures are declining and there are no signs of shrimp aquaculture development in the country. The dependence on a limited number of species causes an imbalance resulting in over exploitation of few and under-exploitation of other species. Also our decreasing average unit prices put extra pressures on the industry for increased volumes. The entire above situation results in a fishing industry where we are catching more and more of limited number of species in already overexploited fishing grounds and selling these at low prices to our foreign buyers. Marine resource mismanagement is also aided by an obsolete fishing fleet and fishing methods, use of banned nets, fishing in prohibited breeding areas, poor landing conditions, highly unskilled fishermen and non-existence of modern fishing, handling and processing industry.

The negligence in exploiting marine fisheries resources is highly regrettable given the state of world markets. Pakistan's share in the world market is less than 0.33%. Given the changing eating habits and depleting natural resources, world seafood market is termed as mainly "sellers market". The focus in fishing is shifting from already exploited regions to under-exploited areas because of conservation and environment pressures

The fisheries sector in Pakistan offers direct employment to over one million people, most of which work as fishermen. A large number of fishermen villages exist all along Pakistan's coast line where fishing has been a primary source of earnings for centuries. The stagnant fisheries sector directly effect standard of living of this community. In addition, these large socioeconomic groups face economic survival problems due to marine resource mismanagement, decreased landing figures and problems faced by seafood processors (who buy their produce) in export marketing because of poor quality product.

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Based on the export potential, current and potential employment opportunities and threats to survival of seafood industry in Pakistan, SMEDA decided to review the industrial value chain from harvesting to processing, with the objective to develop a strategy for optimal utilization of our marine resources. The Fisheries Development Strategy incorporates public and private sector interventions in all effecting areas, i.e., regulation, technology, management, marketing and human resources with a view to increase export earnings, create and sustain employment and bring about qualitative change in lives of millions of people involved in this trade.

4.1.5 Surgical Instruments Industry of Pakistan

The surgical instruments manufacturing cluster is located in the city of Sialkot and its ancillary areas. It has been nearly hundred years that the people of this region have been manufacturing surgical instruments. The industry has transformed from a very small level and low technological base to a highly sophisticated level. The surgical instruments manufacturing has come a long way, from repair of ordinary scalpels and scissors to the manufacturing of complicated surgical instruments. The skill in the industry has reached a stage where it has enabled the industry to manufacture nearly 10,000 different types of surgical instruments.

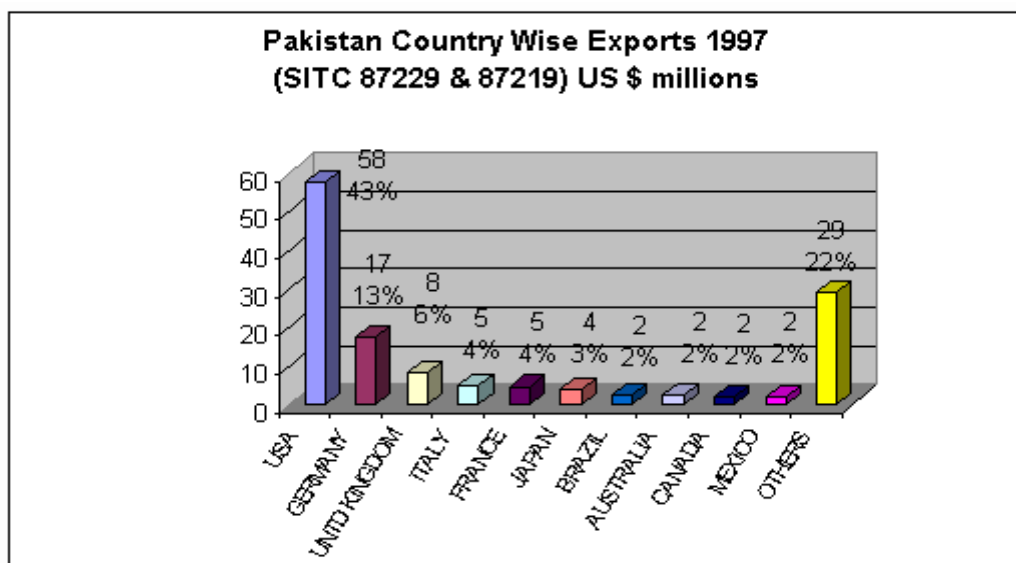
Initially the industry started manufacturing very few basic instruments, to cater to the needs of the local hospital. In the late 1940s the industry got some export orders from Egypt and Afghanistan worth a few thousand dollars. Currently more than 95% of the instruments manufactured in Sialkot are exported to other countries. The surgical instruments sector, if considered as a sub-sector of the light engineering sector, contributes about 70% to the total exports of this sector. The light engineering sector consists of twenty-eight sub-sectors including consumer durables and other industrial products.

➤ Some Basic Facts about the Industry

There are about 2,500 large, medium and small sized manufacturing units within the industry. Some of the units have an in-house facility to perform all the processes.

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Some smaller units specialize in a distinct process and work as sub-contractors for the industry. The surgical instrument industry provides employment to about 50,000 skilled and semi-skilled workers. The production of the industry can be broadly classified into two categories, i.e. disposable instruments and the reusable instruments. The largest market for Pakistani disposable instruments is USA. Majority of the reusable instruments, manufactured in Sialkot, are exported to the European countries.



4.1.6 Gems and Jewelry Sector

Nature has gifted Pakistan with rich deposits of some of the finest and valuable gemstones in the world. Most of these deposits are concentrated in the Northern Areas of Pakistan, Malakand Division, Bajaur Agency etc. A variety of gemstones including Emerald, Ruby, Peridot, Aquamarine, Topaz, which have a world wide demand are mined and traded for local and foreign markets.

Heavy reliance of local market on rough gemstone exports (total of \$12.6 m in 2000-2001) is one of the important challenges for any effort of shifting the industry paradigm from non value added to value added exports. Apart from that, lack of a cohesive marketing strategy with focus on target market requirements, absence of

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financial incentives and problems in custom and airport handling have been observed as factors that hinder accelerated growth in this sector.

SMEDA, with lead support from the industry participants, has proposed a concept of creating an Art and Trade Centre, which would be equipped with gems and jewelry showrooms, cutting and polishing units and one window facilities for gems exports. Moreover, work is also being done on founding a Gemmological institute for uplifting the standards of cutting and polishing skills in the local market. Similarly, a proposal for encouraging documentation of exports in the industry, specific financial concessions for boosting exports of value added gemstones and simplifying export procedures for facilitating exporters has been presented to the government after close coordination with the industry. For the long term sustainable uplift of the sector and shifting the industry paradigm from non value added exports to value added exports, SMEDA is also making a detailed study of the resources, opportunities and trends in this sector under its Gems and Jewelry Sector Development Plan.

Salient Features of Gems Sector Development Plan Being Prepared By SMEDA

1. Modification in Mining and Industrial Regulations towards a more efficient and investor friendly framework, market oriented export and progressive fiscal regime.
2. Coordination of concerned stakeholders and strengthening of trade bodies to effect policy making and support sustainable development measures.
3. Introduction of modern exploration/mining machinery, Gems identification, cutting/polishing and jewelry making equipment through private foreign joint ventures and buy back arrangements. Additionally, setting up of a Gemmological Institute.
4. Identification of local and international market with focused marketing efforts, including a trade center for the display of value added gem products, holding exhibitions and facilitation of foreign and local buyers.
5. A large number of banking and financial transactions for modernization of the industry.

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6. An overriding factor affecting various components of the development plan will be the influence of Afghans with raw materials, entrepreneurial and technical skills.

4.1.7 Bicycle Sector of Pakistan

The Pakistani bicycle market is struggling to establish itself due to smuggled bicycles coming from China and high raw material prices. There is no export presence of Pakistan in this sector and one player monopolizes the local market. For a new manufacturer to establish in this sector, it would need to concentrate on the fancy bicycle segment and can only flourish if they enter into a joint venture agreement with some internationally reputed firm. If bicycle imports from India are allowed, then it will be difficult for the local bicycle industry to survive.

4.2 Finance, Credit and Development Policies and Institutions

SMEs are a robust and vital part of the private sector and play an important role in Pakistan's economy. However, they have not met their potential as an engine of growth and production. As is the case with all the Least Developed Countries, the SMEs sector in Pakistan has been struggling to access formal credit sources. Limited access to finance has been cited by various researches as a significant constraint in the operations of SMEs. Financing is the lifeline of any enterprise __ micro, small, medium or large-scale __ and each has its specific requirements, depending on initial investment needs, working capital requirements and trade financing. An autonomous body is always required who can provide development strategies along with proposing regulatory reforms for the growth of SMEs.

Research reveals that despite the lack of collateral, SMEs are a better credit risk, as the default rate of this sector is much below that of large enterprises (LEs). Throughout the world, SMEs have provided tremendous opportunities to financial institutions to design various tools for the sector's development (e.g. Program Lending Schemes, Credit Scoring, Venture Capital Financing, etc.). Then there are clusters, technology parks and industrial estates, all being fuelled by the dynamism and vibrancy of small and medium enterprises. Banking institutions, running on Islamic principles, are also experimenting

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with interest free financial instruments (e.g. Mudarabah, Murabaha, Ijarah etc.) for this sector.

SMEs need to see the incentive of moving from the informal to the formal sector. It is important to pay equal attention to the development of LSM (Large Scale Manufacturers) since the value adding SMEs rely heavily on the progress of LSM. Presently, some of the SME units survive due to efficiency in the resource use & linkages, others merely by evading taxes and circumventing state regulations.

It will take an immense effort on everyone's part to devise and implement solutions to at least the problems that are self created, or to the issues that can be tackled by using our own resources.

Table: Existing Infrastructure for SME Assistance and Regulation

Institutions	Roles
SME Bank	SME Financing & Business Support Services (BSS)
National Productivity Organization	Creating awareness about the institutional & economic productivity and quality
SMEDA	BSS Provider, Research Body
SECP, SBP	Regulators
Chambers of Commerce & Industry	SME Representation
Commercial Banks / Leasing Companies	Financing
SME Associations	Representation of SME clusters

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4.2.1 Role of SMEDA

The Small and Medium Enterprise Development Authority (SMEDA) was established in 1998, with the objective to provide fresh impetus to the economy through the launch of an aggressive SME development strategy.

SMEDA initially focused on nine priority sectors with the intention of developing sector strategies and proposing regulatory reforms to stimulate growth on the sole criterion of SME presence. In depth research was conducted and comprehensive plans were formulated after identification of impediments and retardants. These strategies as proposed by SMEDA comprehensively covered all important areas of business operation such as regulatory environment, finance, marketing, technology and human resource development. Resultantly, SMEDA successfully formulated strategies for sectors, including fruits and vegetables, marble and granite, gems and jewellery, marine fisheries, leather and footwear, textiles, surgical instruments, transport and dairy.

The task of SME development at a broader scale still required more coverage and enhanced reach in terms of SMEDA's areas of operation. Therefore, after successfully qualifying in the first phase of sector development SMEDA reorganized its operations in January 2001. Currently, SMEDA along with the sectoral focus offers a range of services to the SMEs including over the counter support systems, exclusive business development facilities, training and development for SMEs and information dissemination through wide range of publications. SMEDA's activities can now be classified into following three broad areas:

- *Creating a Conducive Environment; includes collaboration with policy makers to devise facilitating mechanisms for SMEs by removing regulatory impediments across numerous policy areas*
- *Cluster/Sector Development; comprises formulation and implementation of projects for SME clusters/sectors in collaboration with industry/trade associations and chambers*

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- Enhancing Access to Business Development Services (BDS); *take into account development and provision of services to meet the business management, strategic and operational requirements of SMEs.*

Policy planning and Strategy (PP&S) department of SMEDA is the hub of policy and regulatory research that feeds national, provincial and local government institutions, SME associations, industrial clusters and individual entrepreneurs with an ultimate objective of creating a conducive business environment. It has a mandate to identify and where suitable initiate strategic projects. Library and Information resource center of SMEDA is an integral part of PP&S while development of Regulatory Procedures is a part of an overall information dissemination function of the department.

4.2.2 Finance policy and SME access to credit

The State Bank of Pakistan (SBP), the central bank, formulates and implements finance policy and regulate the financial sector. The bank plays a pivotal role in Pakistan's economy, as one of its key functions is to advise the government on monetary and fiscal policy and assist in the implementation of its recommendations. The SBP operates as an autonomous body. Its decisions are based on independent analysis and research of numerous sectors of the economy.

In terms of credit policy, the objectives that drive policy-making encompass employment growth, industrial development, growth of export-oriented industry, commercial viability and enhanced coverage of credit and, most important, measures to restrict willful default on borrowed money.

The financial sector in Pakistan has passed through numerous phases. During the early 1970s, the commercial banks and financial institutions were nationalized, leading to a heavy growth in the branch network of banks, intended to generate more employment. The presence of the banks in the public sector also lead to "political lending", which resulted in a large number of non-performing loans in the overall portfolio of financial institutions. The process of nationalization also imposed

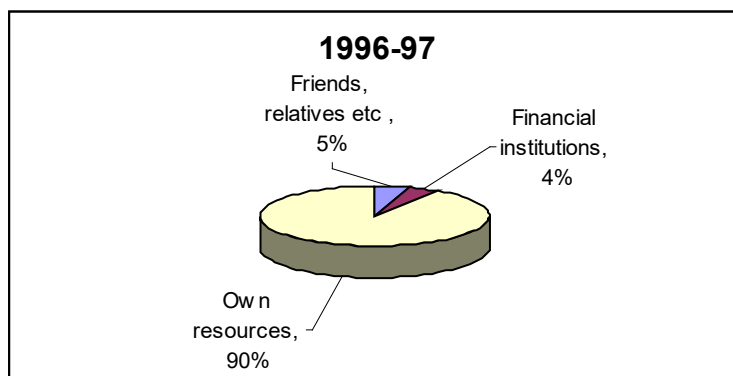
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restrictions on banking activities in the private sector. These factors collectively were responsible for the limited availability of finance for the SMEs sector, as the focus of financing was diverted to large public sector manufacturing concerns and large private sector enterprises.

The late 1980s and the early 1990s ushered in an era of banking reforms: the financial sector was liberalized and banking companies were allowed to operate in the private sector. This led to the development of a number of financial institutions which adopted policies to identify new credit markets.

According to SHMI, almost 17,000 firms in the informal sector obtained credit from financial institutions in 1996-97. However, most SMEs are still unable to access formal credit sources. They finance their business plans through equity or funds obtained from friends and relatives. Figure below shows that among the unregistered enterprises in the manufacturing sector, almost 90 percent run equity-financed business plans. The dependence on funds from relatives and formal financial institutions is limited to 6 percent and 4 percent respectively.

Figure: Financing of manufacturing firms in the formal sector



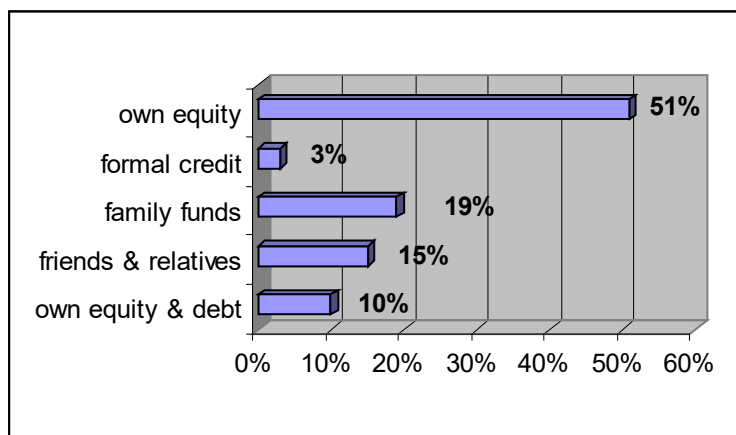
Source: Survey of Household and Manufacturing Industries, 1996-97

These tendencies were confirmed by the SMEDA/Gallup MSE Survey, 2001 which covered SMEs in the manufacturing, trade and services sectors. According to these

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data, 51 percent of the sample enterprises had started their businesses using their own funds. The utilization of credit from formal sources increases with the size of the firm. Almost 8 percent of medium-sized firms have obtained capital from formal financial institutions. Interestingly, the utilization of formal credit was higher than among women entrepreneurs than their male counterparts.

Figure: Source of financing at business start-up in SMEs, 2001



Source: MSED/Gallup MSE Survey, 2001

The slight chances of success in raising finance from formal credit sources may be one reason why most SMEs shy away from them. According to SMEDA/Gallup MSE Survey, 2001 slightly above 20 percent of the entrepreneurs tried to raise some sort of the success rate is also the highest (96 percent) for this source. Commercial banks are considered to be an important source to obtain short-term funds after relatives and friends, but with a lower success rate (66 percent). Other sources, like the specialized provincial government organizations (the Punjab Small Corporation; the Sindh Small Industrial Corporation) and Non-Bank Financial Institutions, are rarely accessed. Similarly, in order to meet their long-term capital needs, SMEs tend to access family and friends as a first choice after equity. Formal credit sources are not regularly accessed. Surprisingly, the SMEs do not seem to rely on informal money-lenders to meet their long-term capital requirements.

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The success rate for medium-sized firms was between 75 percent to 100 percent in the case of short and long-term loans from commercial banks, mainly because a large number of medium-sized firms have formal structures. For micro and small enterprises, the success rate was much lower.

It is very important to determine the factors that influence investment decisions. According to the SMEDA/Gallup MSE Survey, almost 57 percent of the SMEs surveyed make investment decisions in response to market demand; 44 percent cited the premises in which the enterprise operates; and 37 percent cited their access to financial resources. Among the factors that have a negative impact on investment decisions of SMEs, government policies were reported by 32 percent and payment to workers by 30 percent of respondents. Factors having no impact were: structure of the business (58 percent), special incentives (57 percent), government policies (41 percent) and access to resources and inputs (40 percent).

Given the importance of access to finance, and despite the fact that government has initiated specialized credit programs for SMEs development, government policies at a broader level seem to have a negative rather than positive influence on investment decisions in SMEs.

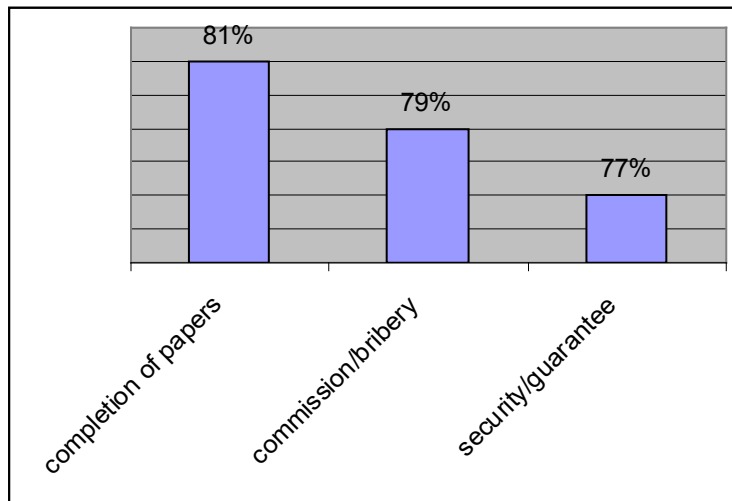
4.2.3 Prudential Regulations and documentation requirements

As discussed in the preceding paragraphs, financing is regulated by the SBP. Its prudential Regulations stipulate that banks and financial institutions need to secure loans with realizable security. The financial sector has gone one step further; loans are given after obtaining collateral to the value of 120 to 130 percent of the loan size. One of the foremost problems confronted by the small and medium enterprises in obtaining formal credit is their non-availability of collateral. This observation is confirmed by recent World Bank-Gallup study of 500 SMEs in Pakistan, in which 77 percent of small-enterprise investors were discouraged from making investment decisions because of perceived problems with collateral. Recently, the SBP has

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allowed collateral-free lending up to PKR 100,000, to facilitate micro enterprise development.

Figure: Problems faced by SMEs in securing formal-sector loans



The growth of SMEs is significantly hindered in Pakistan because there is no mechanism to replace collateral. SMEs in developed countries face similar problems with collateral but the issue is resolved through innovative measures, such as credit guarantee schemes offered by private sector firms and industry associations. In Japan, for example, the chambers and industry associations provide guarantees on behalf of borrowers to financial institutions. In Canada, France and the United Kingdom, credit guarantee schemes have been introduced, which secure a given proportion of the loan by charging a premium at market interest rates. In Canada, for example, the credit guarantee covers almost 90 percent of the total amount borrowed by charging a premium of 1.75 percent on interest rates. Applied on a commercially viable basis, similar measures can assist the SMEs in Pakistan to enhance their capacity to access formal credit sources.

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A second obstacle for SMEs in Pakistan is the documentation requirements of financial institutions to process loan requests. This issue has three main features: the lack of book-keeping practices in the SMEs, the structure of these businesses, and the heterogeneity in basic documentation of financial institutions.

Micro enterprises are mainly sole proprietorships, a structure that does not legally require the maintenance of record books of accounts and audits. The Prudential Regulations of the SBP have taken this into account for micro enterprises and the lower end of the small-enterprise sector. Table below sets out the documentation requirements for the micro-enterprise sector, stipulating that accounts only need to be signed by the entrepreneur/borrower. This provision acknowledges the lack of capacity of micro enterprises to maintain records of financial statements.

For firms which require a maximum of PKR 10 million credit, the accounts need to be audited externally. A range of options is available in the Prudential Regulations to facilitate borrowing. However, this entails extra costs for the small enterprise, as professional assistance is sought from chartered accountants.

Table: Documentation requirements according to Prudential Regulations

Limit on formal lending	Requirement of financial statements
Loan not exceeding PKR 2 million	Accounts duly signed by the borrower
Loan exceeding PKR 2 million but not exceeding PKR 10 million	Accounts duly signed by borrower and countersigned by: The internal auditor of the bank or: A chartered accountant or; A cost and management accountant in case of a borrower other than a public company or a private company

Source: State Bank of Pakistan, 1999

Finally, bank procedures contribute to making access to credit difficult for SMEs with limited in-house capacity. For example, the basic loan request form is not

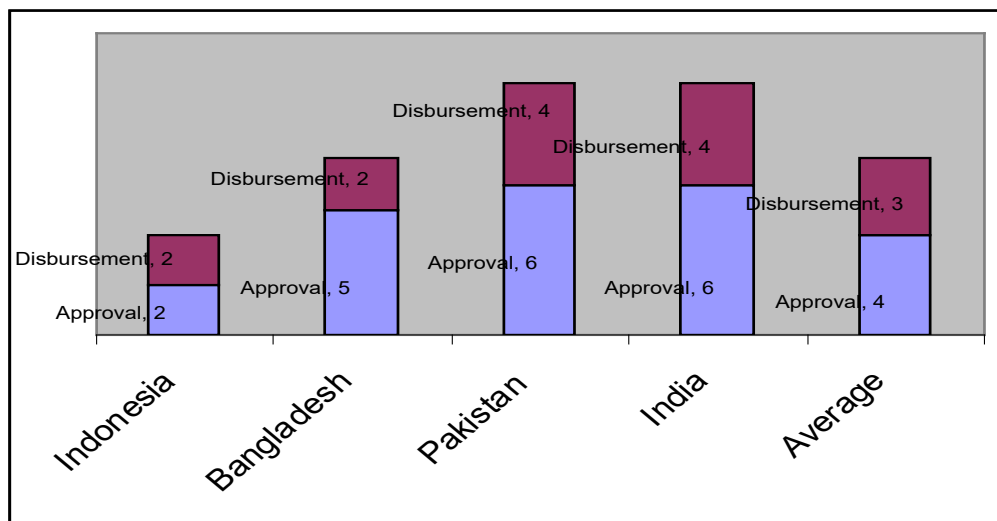
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standardized within the financial sector. Each financial institution has its own form, the contents of which vary from bank to bank. Standardizing these procedures across the financial sector would enhance the capacity of the SMEs to complete the forms and comply with procedures without incurring the extra costs of external assistance.

As stated earlier, a majority of SME business plans are equity-financed. The Prudential Regulations of the SBP set the debt-equity limit at 60:40 for fresh loans and additional loans required for expansion. This cannot be considered to have any negative effect on the access of SMEs to formal credit sources. To promote investment in selected sectors, the Prudential Regulations have lowered the debt-equity ratio. This example of good practice could be extended to encompass the SMEs sector (after first giving it a standard definition).

Regardless of firm size, the transaction costs charged by financial institutions for the processing and monitoring of loans are similar, since large enterprises are perceived as less risky than smaller ones.

Figure: Time involved in loan-processing by financial institutions in selected Asian countries, 1999



Source: International Trade Center, the SME and the Global Marketplace: An analysis of competitiveness constraints

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Figure above compares loan-processing time in financial institutions in Pakistan with other selected Asian countries. The average time in Asia is four months for the approval process and another three months for disbursement. In Pakistan, the average time taken for approval and disbursement is ten months, or three months higher than the Asian average.

Considering the size of the enterprises and the relatively small amounts required by SMEs, processing times could be streamlined. If minimum requirements were introduced for processing SMEs loan requests, would encourage these businesses to seek more financial assistance from the organized sector.

No timeframes are set for loan processing in the Prudential Regulations, which stipulate only the key areas that need to be evaluated in –depth before loan approval and disbursement. It would be an easy step to formulate standardized procedures for the SMEs sector in the Prudential Regulations for the purposes of evaluation and assessment, which would also streamline loan-processing time.

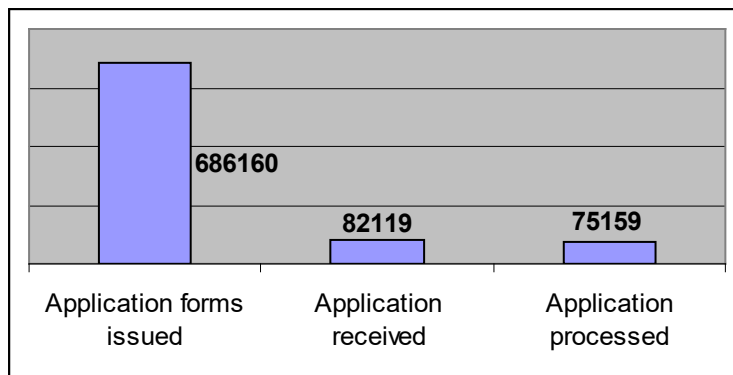
Another obstacle to SME access to formal credit is their lack of awareness of numerous SBP incentive packages and provisions. For example, very few entrepreneurs are aware of the Clean Lending Limit, a provision that can facilitate SMEs in borrowing small amounts to meet their short-term capital requirements. The limit is currently too low to cater to the capital needs of a broader band of firms, but if proper awareness is created about this facility, a number of SMEs can benefit from it.

Figure below demonstrates the effectiveness of awareness-raising campaigns. The Self-employment Scheme was started to provide small loans up to limit of PKR 500,000 with the objective of creating employment. This scheme was very well marketed through various media to make the general public aware of this credit facility. As a result, almost 700,000 application forms were issued and more than 80,000 applications were received.

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Similarly, had there been awareness about the Clean Lending Limit in the SMEs, a number of enterprises with short-term capital needs would have preferred to access the formal sector rather than paying 40 to 50 percent premium on prevailing interest rates to money-lenders in the informal sector.

Figure: Results of the Self-employment Scheme, 1999



Source: SMEDA

The State Bank of Pakistan also regulates the Non-Banking Financial Institutions (NBFIs) in the country, including leasing companies, Modarbas and Musharikas. Most of their regulations are similar to those of the commercial banks, with the same effect on financing. The only regulation that could play an important role in SMEs development is the limit set by the State Bank for small-business financing. All NBFIs are required to allocate 5 percent of the total loan portfolio to small enterprises. This can prove to be very useful in extending formal credit to small enterprises, if the limits set are observed and properly implemented.

A similar provision for commercial banks could achieve positive results in opening up new vistas of formal sector financing for small enterprises. It would also achieve a wider branch network for commercial banks, by enhancing reach to far-flung rural areas, and help to familiarize small enterprises with the concept of debt as a traditional mode of financing.

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4.2.4 Targeted credit schemes

To address some of the problems of SMEs access to the banking system, several targeted credit schemes have been set up by government authorities, banks and NGOs. Some of these initiatives are discussed below.

➤ *The Khushali Bank (a micro-credit bank)*

The Khushali Bank has been established recently and its first branch has begun operations in Dera Gazi Khan. Its mandate is to provide a total credit disbursement of up to PKR 60 billion over 5 years to total of 5.6 million individual who are not a part of the tax net. In the case of partnerships, the scheme is limited to enterprises earning less than PKR 30,000 a year.

The objective of this particular initiative is to alleviate poverty through providing micro credits. Since it is only in the initial stage, its impact remains to be seen.

➤ *First Women's Bank (a micro credit scheme)*

The First Women's Bank (FWD), established in 1989, as also successfully carried out a micro-credit scheme solely for women entrepreneurs in rural areas. The FWB is the only commercial bank that disburses micro credit to women entrepreneurs. Unlike big commercial banks, the FWB extends advances and loans on a smaller scale (maximum PKR 25,000) and has managed to maintain a 100 percent recovery rate. The basic aim of the bank is to empower women, especially those from low and middle-income groups.

➤ *Financial institutions: The Small Business Finance Corporation and the Regional Development Finance Corporation*

The Small Business Finance Corporation (SBFC) was established in 1972. Since its establishment, it has been used as a platform for disbursing loans at low interest rates. Lending strongly favored the self-employment scheme, which disbursed micro

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credits. SBFC has been recently restructured by the government to cater to the needs of wider range of enterprises. For this reason, SBFC has also redefined its target group by enhancing the upper limit of productive assets to PKR 100 million for medium-sized firms.

The Regional Development Finance Corporation (RDFC) was established in 1985 with the specific objective of promoting the industrialization of less developed regions. RDFC is a multi-product financial institution. It participates in money market, capital market and micro credit delivery. Besides financing medium to large-sized industrial concerns, RDFC has been involved in disbursing micro and small-sized loans.

➤ *Self-employment Scheme*

The Prime Minister's Self-employment Scheme (SES) was launched in June 1998, to provide employment opportunities to jobless or low-income individuals. Initially, it was instigated by the SBFC; later, other banks, such as the National Bank and the Allied Bank also participated. The scheme is almost non-functioning, although it has not been officially abolished. Earlier, SES provided loans with a maximum of PKR 500,000 to eligible applicants. The requirement for obtaining a loan included a personal guarantee or mortgage of non-encumbered property with a value equivalent to the loan amount. The loan carried a 15 percent mark-up and the repayment period was 7 years with a grace period of 6 months to a year.

As its objective was to create employment across the economy at a rapid pace, the focus of SES was not solely on the manufacturing sector. All the government-owned commercial banks and the specialized DFIs actively participated in the scheme and more than PKR 6 billion worth of loans were disbursed. The actual performance of the scheme based on category of loans and their default rate cannot be evaluated, as no statistics are available. However, based on the disbursement figures and assuming that each loan created one job, an estimated 34,000 new jobs have been generated.

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➤ Export Finance Schemes

The first Export Finance Scheme was established in 1972 to provide a credit facility on favorable terms for the export of goods. Finance is divided into two stages: in stage 1, working capital is provided; in stage 2, a finance facility is provided for a loan amount equal to five-twelfths (41.66 percent) of the total value of exports in the preceding year. The interest rate of only 8 percent is far below the prevailing market interest rate __ a feature of the scheme that makes it a very useful tool for exports development.

In 1998, the scheme was revised to make it available to SMEs. Now not only SMEs can benefit from this scheme but also new and indirect exporters who have exported hoods up to a maximum of US \$2,500,000 in the preceding fiscal year are eligible. Based on the new modified scheme, the incentive of subsidized credit is also available to the indirect exporter (which acts as a supplier to the exporter). However, the “trickle-down” effect in terms of the small-scale enterprise benefit has not yet been achieved. This policy intervention place an initiative on direct exporters, requiring them to open an inland Letter of Credit in favor of the local SME supplier. But the attitude of large-scale business and the low awareness levels among small-scale entrepreneurs result in this initiative being taken up only rarely. Thus, local suppliers and manufacturers who are indirect exporters could also benefit from such incentive schemes. As a matter of policy, the government plans to increase the interest rate and bring it in line with prevailing market rates, reducing its utilization by direct exporters.

➤ Pakistan Export Finance Guarantee Agency

The Pakistan Export Finance Guarantee Agency (PEFG) was established with an authorized capital of PKR 610 million. Its objectives include providing a comprehensive range of export trade finance guarantees to exporters, indirect exporters (a majority being SMEs) and other growth sectors. PEFG issues bankable guarantees on behalf of new and small exporters, in favor of partner banks who will provide trade finance facilities from_US \$100,000 up to the maximum limit of US

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\$2.5 million a year. It also provides up to 80 percent repayment guarantee, up to US \$100,000 (in Pakistan rupee equivalent at prevailing exchange rate) per transaction. The guarantee can be substituted for traditional collateral and is accepted as such by participating banks. This guarantee is targeted primarily to the SMEs and to more established but emerging exporters wishing either to enter new markets or introduce new products.

PEFG can be considered as good practice since it replaces traditional collateral requirements with a competitively priced PEFG certificate, which is used as a guarantee to financial institutions when considering pre-shipment export loans. This is of real benefit to SMEs in the export business. However, firms operating solely in the domestic market cannot access any credit source without collateral.

4.2.5 Summing up

Traditionally, the SME sector in Pakistan has depended on equity financing not debt financing to meet short and long-term capital and trade credit requirements. Various factors have contributed to this position: lack of awareness of the government regulations under which financial institutions operate; the informal nature of business; a lack of collateral; interest payments; and the lack of capacity to comply with auditing or documentation requirements.

At the policy level, consistent government efforts have been made to enhance the access of the SMEs to formal credit sources. Realizing that most of these enterprises operate as proprietorships, the Prudential Regulations waiver small firms from documentation requirements. Similarly, the State Bank of Pakistan has also allowed collateral-free lending up to PKR 100,000 to facilitate micro enterprise development.

To meet the credit needs of micro enterprises, the government has also established the Khushali Bank, providing small loans of up to PKR 30,000. Similarly, specialized financial institutions, such as the First Women's Bank, cater to the credit needs of

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women entrepreneurs. Recently, the Government announced the establishment of an SME Bank proactively engaged in extending credit to the SME sector.

As far as trade financing is concerned, the State Bank of Pakistan offers export finance at subsidized rates. This scheme has been modified to take into account the need of small and medium-sized indirect exporters. Similarly, the Export Finance Guarantee scheme has been initiated to facilitate the small and medium-sized exporters by replacing traditional collateral with guarantee.

Notwithstanding these efforts, the SMEs still do not consider formal credit sources as their main source of funding, because collateral requirements are major deterrent. The foremost issue is the absence of cash flow based lending in the financial system of Pakistan. Other impediments include the lack of awareness among SMEs on the program and incentive packages of various financial institutions, non-standardized credit application and loan evaluation procedures, and a lack of understanding about different financial tools, such as leasing.

Formal sector financing avenues are being introduced into finance policy in an attempt to widen the tax net in Pakistan.

4.3 Government role in SMEs Promotion

Realizing the role of the SMEs in the economic revival of Pakistan, the government established a high-powered Federal-level agency. Small and Medium Enterprise Development Agency (SMEDA) is to launch aggressive SME support programs. SMEDA is playing the role of a one-window information and support resource base for the SMEs. It will develop both firm and policy level knowledge-base to assist in the development of SMEs. It will only provide the perspective and point of view of the SMEs. It will not only provide the perspective and point of view of the SMEs to the government, but will also assist in coordination and implementation of such policies and plans.

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Simultaneously, having understood the importance of having specialized vehicle to deliver financial services to the Small and Medium Enterprises (SMEs) sector, which currently has poor access to formal sources of financing, the government of Pakistan also took the initiative of reorganizing the Small Business Finance Corporation (SBFC) in the year 2000 to support the financial and technical needs of SMEs; and to enable it to play its due role in the economic uplift of the country. Recently, SBFC has been transformed into a specialized SME Bank to cater to the financing needs of the SMEs.

In 2001, the government also took the initiative to revive National Productivity Organization in order to strengthen SMEs. To revitalize this crucial sector, NPO has following the role to play:

- Job creation and human resource development
- Improvement the working environment of the informal sector
- Productivity with quality of life and poverty reduction
- Integration with a cluster and networking development program for SMEs in selected sector/regions i.e. textile, leather, fisheries, agro industry, gems and jewelry, etc
- NPO will also help SMEs in establishing a more efficient management, with appropriate technology, a stable financial position, and proper channels through which information can be shared (knowledge management).

According to the Pakistan 2012 program, the government would like to see SMEs to develop from labor intensive industries to technology oriented industries through technological transformation and IT application, thereby realizing their full capabilities. Also, venture capital for businesses is being heavily promoted. Recently, Venture Capital Fund Management Rules have been finalized by the Securities and Exchange Commission of Pakistan and notified with seven years income tax holiday for venture capital funds.

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There are various promotion policies for SMEs which are and were undertaken by the government for boosting this sector. Some of them are mentioned below:

4.3.1 Labor Policy

While the trade and fiscal policy is announced annually, labor policies have been formulated far less frequently than any other Pakistan's policy framework. The first labor policy was announced in the 1970s, the next and most recent in 2001 __ a gap of almost three decades. During this period, the labor force has increased enormously. Developments in minimum wages, working hours and standards, technological changes and even the global economy have not been given due importance through up-to-date policy reform.

The Ministry of labor, Manpower and Overseas Pakistanis is mandated to perform the function of policy formulation regarding administration, labor force planning and employment promotion, in close coordination with the provincial governments. The Ministry of Labor uses a tripartite approach, incorporating the views of representatives of employers, workers and government.

The main areas of focus for a successful labor policy are (i) strategic government management of labor so that qualified and trained labor may be supplied to meet industry demands and (ii) the provision of fundamental rights for workers and employers.

The following departments fall under the jurisdiction of the Ministry of Labor, Manpower and Overseas Pakistanis:

- Workers Welfare Fund
- Directorate of Labor Welfare
- Employees Old Age Benefits Institution
- Employees Social Securities Institution
- Bureau of Emigration and Overseas Employment
- Directorate of Workers Education

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- National Industrial Relations Commission
- National Training Bureau

No specific measures or targeted action plans for SMEs are mentioned in the Labor Policy 2001, despite the high share of employment in this sector. Although a move to encompass the informal sector in the ambit of labor regulations was announced in the Labor Policy 2001, the coverage of policy initiatives is still limited to important urban centers. Micro entrepreneurs in the rural areas thus lack awareness of the regulatory framework and various incentive packages and schemes on offer.

Both the Employees Old Age Benefit Institution and the Employees Social Securities Institution have recently reduced the minimum enterprise size for compliance from 10 to 5 workers, with the option of voluntary registration. This is the first step in the process of increasing the scope and coverage of labor regulations in Pakistan.

Two major factors hindering compliance are the time consumed in government interaction and the vast number of laws to be complied with. For example, compliance with one regulation usually obliges businesses to comply with a whole range of associated laws.

This tends to result in entrepreneurs opting to remain in the informal sector, or underreporting their number of workers.

At the provincial level, federal laws are translated into provincial rules for the proper implementation of the labor code. Many laws have overlapping functions. Considerable work has been done to rationalize these laws in order to achieve an efficient and effective labor code. To achieve accountability and enforce these laws, the labor courts and tribunals play a crucial role.

One of the most pressing issues for the labor policy platform is the cost of compliance ___ in terms of both time (spent dealing with various compliances issues with various

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departments) and money. The general consensus is that there are far too many labor laws in Pakistan. Especially for the micro and small sized firms, obligatory compliance would be considerable problem. But, as mentioned earlier, micro enterprises are exempt from several of the labor laws applied to business entities with 10 or more workers.

The social welfare system in Pakistan is inadequate because of a number of constraints within the economy and in policy implementation. The following laws and regulations deal with social welfare:

- Employee's Old Age Benefit Act, 1976
- West Pakistan's Maternity Benefits Ordinance, 1958
- Workers' Warfare Fund Ordinance, 1971
- Workers' Children (Education) Ordinance, 1972
- Provincial Social Securities Ordinance, 1965
- Company Profits (Workers' Participation) Act, 1968

These laws all relate to job quality, in that their main function is to provide benefits to the workforce. It is every employer's legal responsibility to pay social security contributions according to specific regulations. The laws provide details on the method of assessment and collection of these labor from the employer. Many enterprises, especially in the SME sector, avoid paying social security contributions by remaining in the informal sector.

The SMEDA/Gallup MSE Survey, 2001 provides empirical evidence on the frequency of inspection visits by officials from government authorities dealing with labor policies. As shown in table above, the number of visits increases with enterprise size, in line with legal requirements (registration is mandatory for enterprises with 10 or more workers). Only 5 percent of the micro enterprises of the sample, but 21 percent of the small enterprises and 31 percent of the medium-sized enterprises had been inspected during the two years prior to the survey. Inspection visits were found to be more frequent in the manufacturing sector (22 percent) than in the trade and

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service sectors (7 percent). This may be due to the mandatory compliance with the Factories Act which particularly concerns manufacturing enterprises.

Table: Frequency of inspections and registration with labor departments in SMEs, 2000

Labor departments		Labor		Size			Sector		
		Urban	Rural	Micro	Small	Medium	Trade	Services	Manufacturing
Total No.	333	201	132	167	127	39	102	124	107
<i>Visited by Labor Depart. Official (%)</i>	15	22	4	5	23	31	7	15	22
<i>Registered at the EOBI* (%)</i>	14	22	2	3	21	36	6	15	22
<i>Registered at the ESSSI* (%)</i>	8	13	1	1	13	23	4	8	12

Note: ESSSI= Employees' Social Security Institution

EOBI= Employees Old Age Benefit Institution

Source: SMEDA/Gallup MSE Survey, 2001

With regard to social security coverage, 86 percent and 92 percent of the sample SMEs are not registered with the EOBI and ESSSI respectively. Even the small and medium-sized enterprises, whose registration with social security offices is compulsory, report low levels of registration. This could be due to major under-reporting on the part of employers with more than 10 workers, as well as inefficiencies in labor department registrations. The coverage is especially low in rural areas, where only 1 percent of the sample SMEs are registered with the ESSSI. The low coverage ultimately results in inadequate job quality in the form of underutilization welfare benefits, which should be provided by these institutions.

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Gender-related laws in Pakistan are generally unbiased and fair but the cultural environment in which they are implemented traditionally restricts the active participation of the women in the labor force. Only the agricultural sector offers roughly the same opportunities to women and men, given that the priority in the rural areas is to achieve a sustainable household income.

Within the regulatory framework of Pakistan, the rights of women workers are protected with regard to maternity benefits. However, while best practices abroad suggest that this benefit should be partly paid by government through subsidies, this is not the case in Pakistan and thus may result in employers preferring not to hire women. Moreover, according to the Factories Act 1934, no women worker is allowed to work after 7 p.m. till 6 a.m. in a factory. Although the reason for having this clause is to provide extra protection to the female work force, it can act as an entry barrier for female workers. The extent to which these laws are applied and implemented among the SMEs cannot be determined exactly, but it is likely that most small and medium-sized enterprises in the formal sector are forced to comply. Apart from maternity benefits, other laws relating to wages and working conditions accommodate the specific needs of women.

If laws are properly enforced and women are made aware of these laws and informed of their fundamental rights, this could have a positive effect on their participation rate. However, awareness of these laws is even lower in the SMEs sector than in larger enterprises. Women tend to be employed only for specific “female” tasks such as embroidery or sewing.

4.3.2 Taxation Policy

At present, there is no specific taxation policy within Pakistan’s policy framework. Taxation reforms are made through tax measures announced annually in the fiscal budget. In the past decade, Pakistan has seen a shift from indirect to direct taxation. While the tax base for most of the taxes grown faster than GDP in Pakistan, tax rates

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have been reduced, so that tax revenues are stagnant when measured as a share of GDP.

The primary aim of government tax measures is to increase the tax-to-GDP ratio. The government previously increased revenue by increasing the tax rates for existing taxpayers. The recent national shift in tax policy is to broaden the tax base and bring about a more equitable system of taxation.

The structure of taxation policy is invariably sector-specific, but in the present situation tax measures cannot be announced on the basis of enterprise size, or translated into size-specific objectives, due to the lack of a standard definition of SME establishments __ a lack that is emphasized throughout this report. Both the Ministry of Finance and its implementing agencies do not recognize the micro, small and medium sector. The varying definitions within each institution create confusion, particularly in regard to tax incentives. Attempts are now being made by the government to offer tax incentives to the micro and informal sector so that they may enter the tax net.

Consequently, taxes are imposed on specific sectors where the assessment criteria are easier. For this reason, fully documenting the economy is urgently needed. This will increase the statistical data currently available and allow sizes of industries and sectors to be defined more comprehensively and coherently.

The main taxes imposed and collected at federal level include taxes on income (other than agricultural), on capital value of assets, customs duties on international trade, excise duties, and taxes on the sale and purchase of goods produced, exported, imported, manufactured or consumed. The administration of Pakistan's tax systems such as income tax, sales tax, central excise and customs is within the CBR and its subordinates departments.

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The CBR collects tax revenue through various federal and provincial taxes. Apart from the federal taxes collected (via provincial collectorates) within each province, there are additional taxes based on infrastructure requirements, specific sectors and types of human resource. Table below illustrates federal and provincial taxes, taking Province of Punjab as an example. Certain sector-specific provincial taxes have been included, to demonstrate the high number of taxes imposed on enterprises.

Table: Taxes imposed on enterprises in Pakistan, 2001-02

Taxation	Federal Level	Provincial Level (Punjab)
Direct Taxation	Income Tax Wealth Tax	Property Tax
Indirect Taxation	Sales Tax Central Excise Tax Customs Tax	Punjab Sales Tax Punjab Excise Tax Cotton Fee Professional Tax Hotel Tax Registration Fee Corporation Taxes Capital Value Tax Local Council Fee (for rural areas)

Source: SMEDA

The impact of these different taxes is twofold. First, each type of tax forces the enterprise into interaction with the relevant government agency __ a source of considerable costs in time that bear on the productivity of the SME entrepreneur. Second is the financial drain of the numerous taxes imposed. When entering the formal net, smaller sized firms conduct a cost-benefit analysis to determine the benefits of such a move. Given the number of taxes and the level of interaction with government agencies (often perceived as having associated corruption costs), many SMEs prefer to remain in the undocumented informal sector.

➤ **Implementation of taxation policies**

✓ ***Tax administration: Complexity, hierarchy, red tapeism***

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The CBR has appointed tax collectorates at the provincial level. Collectorates for income tax, sales tax, excise and customs are separate and each has more than nine fields in which they operate. The structure of various tax departments is exceedingly complex. For example, in the sales tax department the hierarchy of authority levels begins with a member of sales tax, followed by chiefs, then joint directors, the executive collector and the adjudication collector. The sales tax department is composed of six divisions: registration, assessment and processing, refund, audit, enforcement and computerization. The registration division is split into de-registration, registration and compulsory registration departments, while the enforcement division has recovery, survey and other functions departments. The results of the complexities of departmental structure are endemic bureaucracy, red tapeism, and a business community spending considerable amounts of time and resources in dealing with tax issues. For SMEs in particular, with low awareness and understanding of the tax system, this complicated structure only adds to the confusion of the castor. Interaction with tax officials takes place on successive levels of the departmental structure and at each different stage the SME entrepreneur is confronted with different multiple form-filling. Unfamiliarity with paperwork, a lack of the requisite human resource management skills, and the time lost in productivity are barriers to the entry of the SME sector into the tax net.

The concept of the taxpayer as client is unknown to the taxation officials in Pakistan: many interactions between taxpayers and the income tax department, be it assessment, obtaining refunds or exemption certificates, are fraught with unnecessary hurdles and delays that border upon harassment.

✓ Perceived corruption and speed money

The CBR is perceived as an infrastructural an administrative mammoth: it has approximately 33,000 employees and under current regulation, extremely wide discretionary powers. It is generally considered prone to high levels of corruption. In its fundamental role of collection, the tax administration is relatively weak ___ one of the reasons the tax to GDP ratio has not increased. A recent study estimated

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revenue losses in the three main departments as 64 percent in the income tax department, 48 percent in customs and 45 percent in the sales tax department.

Overnight changes in the tax structures, accomplished by issuing SROs, have had a major negative impact on the SME entrepreneurs. Most are not aware of the extent of the changes, leaving room for administrative manipulation of taxpayers at some cost. Proper guidance in how to deal with the changes is not available. In addition, SMEs face the possibility of extortion during the assessments of their accounts. The SME entrepreneurs are not sufficiently educated or familiarized with the tax system; tax collectors, aware of this weak point, may exploit them. On the sales tax front, tax collectors have greater chances of extortion: aware that exporters must meet deadlines, they may delay the assessment of imported items. Speed money is the most common form of corruption.

In order to obtain a refund urgently, the SME bear the cost of PKR 10,200 __ a good reason for their reluctance to avoid entering the tax net. The other form of speed money expenses is as a percentage of the refund amount. This percentage ranges between 0.5 to 2 percent, depending upon the amount of refund (*source is Government of Pakistan, Task Force on Reforms of Tax Administration: Study on Corruption, July 2001*). The rates of speed money are inversely proportionate, i.e. the smaller the amount of refund, the higher the rate of speed money.

✓ *E-Government Project*

Although this project is not targeted to SMEs, it should be mentioned here in the context of government response to public opinion. In an attempt to cut red tapeism, the aim of the E-Government Project is, initially, to develop web pages of all government departments that are involved in public dealing. This step has been taken to create broader awareness through connectivity to the internet; later phases will provide online solutions to the public in dealing with government departments and to reduce interaction. The CBR now has a website providing online

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information and from 2001 onwards tax return forms could be accessed and completed online by computer-literate taxpayers. Such measures, if implemented across-the-board, can significantly improve the regulatory environment by introducing transparency and reducing interface with government officials.

To gain an understanding of the scope and level of interaction between SME entrepreneurs and the tax authorities, Gallup considered the registration process.

➤ **Registration with tax departments**

For the purpose of this report, Gallup conducted a survey on SME interaction with tax departments. Table illustrates the share of registered units in various types of enterprise. The scope of the tax authorities varies in relation to geographical location. The share of registered units is 70 percent in urban areas, compared to 40 percent in rural areas. This is indicative of the limited scope of the tax administration and its difficulty in encompassing the rural sector into the tax net. This is one reason why Pakistan has one of the lowest tax bases in the world.

Table: Scope and interaction with Tax departments in SMEs according to geographical location, 2001

Registration

Agency		Gender		Location		Sector of Business		
		Male	Female	Urban	Rural	Micro	Small	Medium
Total cases	333	285	48	201	132	167	127	39
SMEs registered with the following agencies (%)								
Income Tax	58	61	38	70	40	44	68	85
Sales Tax	44	49	15	49	37	31	54	72
Excise Tax	20	22	2	28	6	8	27	46

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Source: SMEDA/Gallup MSE Survey, 2001.

Tax official visit

Tax official visit	Total	Location		Size			Sector of Business		
		Urban	Rural	Micro	Small	Medium	Trade	Service	Manufacturing
Cases	333	201	132	167	127	39	102	124	107
Income Tax Depart.	37	33	45	39	38	24	42	37	33
Sales Tax Depart.	33	35	29	39	26	38	24	31	42
Central Board Revenue	10	14	2	0	18	14	8	15	7
Army Survey Teams	8	8	10	12	5	10	18	4	5

Source: SMEDA/Gallup MSE Survey, 2001.

The number of registered units and visits increases with enterprise size. The larger the number of workers employed, the greater the interaction with government, both in registration and visits. Another interesting with sales tax authorities, compared to 59 percent of men entrepreneurs. This may indicate a greater unfamiliarity or lack of awareness of taxation among women entrepreneurs.

The SMEDA/Gallup MSE Survey also evaluated the decision-making process for SME owners with regard to employment, investment and registration. Respondents (63 percent) were positively influenced by the availability of insurance and official protection offered when registering for income tax; 42 percent of respondents were negatively influenced by fines and harassment associated with income tax

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registration. When deciding to increase or reduce the level of employment within their enterprise, the priority given to tax issues was relatively low.

4.3.3 Trade Policy

Trade policy in Pakistan aims at maximizing the gains from international trade and encouraging an efficient and competitive domestic market. Export promotion and import substitution are the two key elements, with the current emphasis on developing industries that can sustain competitive advantage. Incentives are provided to enable these industries and sectors to meet the challenges of globalization. The Ministry of Commerce determines the direction of Pakistan's economy through the analyses of trade regulations. Trade policy is formulated each year and short-term measures are adopted. Formulation is an interactive exercise, incorporating various incentives and sector development strategies from other government departments and representative institutions, as well as defining the numerous procedures relating to imports and exports.

➤ Policy formulation: A lack of SME-specific measures

As already been noted in the tax policy section, the lack of recognition of the SMEs is evident in the trade policy framework also. The focus for strategy is on the economic sector (agriculture, manufacturing and services) and not on enterprise size.

To date, no SME-specific plans have been formulated and the SME sector is not represented. Input is obtained from key industry and trade associations in the country (currently over 140 organizations). To ensure regional coverage during the policy-making process, the Chamber of Commerce and Industries, which are dominated by large-scale industries and trades, take the leading role. The industry associations, which represent specific sectors, are left out of the policy-making process. Moreover, mainly for political reasons, there is no structured framework

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to regulate industry associations, so that several different industry associations exist __ even in one sector. This further dilutes the representation of SMEs in trade policy formulation, in favor of the large-scale firms and the organized sector.

Table: SME registration with industry and trade associations (percentage), 2001

	Total	Sector of business			Size of business		
		Trade	Services	Manufacturing	Micro	Small	Medium
Registration with Chamber of Commerce (%)							
Yes	20	10	10	40	7	28	49
No	76	88	85	55	90	68	44
Registration with Industry Association (%)							
Yes	27	15	29	36	10	39	59
No	71	83	68	62	87	60	38

Source: SMEDA/Gallup MSE Survey, 2001.

As table shows, only 20 percent of SMEs surveyed are registered with the Chamber of Commerce. A slightly higher number, 27 percent, are registered with an industry or trade association. Representation of enterprises in these organizations increases with enterprise size. Thus, large firms are able to safeguard their interests at a national level whereas SMEs are neglected in vital decisions at the policy level. However, size is not the only reason that restricts an enterprise from membership in industry and trade associations. In general, SME entrepreneurs lack awareness of the role of industry and trade associations and do not recognize the use they can make of this platform to voice their concerns. In general, SME entrepreneurs lack awareness of the role of industry associations and do not recognize the use they can make of this platform to voice their concerns.

➤ **Importance of trade for the SME sector**

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The survival of SMEs in Pakistan largely depends on trade. As manufacturers of finished products, the SMEs import various industrial inputs; as exporters they contribute significantly towards total national exports. It is impossible to estimate the exact share of SMEs in total exports because no data are reported.

A large majority of enterprises in the informal sector contribute indirectly to total export earnings, with process vendors operating in almost all the industrial sectors. The textile industry contributes almost 60 percent to national total exports, of which 25 percent are fabric exports. Fabric manufacturing in Pakistan is concentrated in the un-organized “Power Loom” sector. Located in Faisalabad, its small manufacturing units account for more than 60 percent of the total fabric production in Pakistan. Although it is the country’s major producer of fabric, the power Loom sector is not a direct exporter, but it serves the needs of commercial exporters and suppliers to international markets.

Similar examples abound: surgical instrument manufacturing and the sports goods manufacturing and apparel industry (all with large numbers of small vendor) operate as suppliers or indirect exporters. There is also a large presence of direct small and medium-sized exporters in these sectors, so a conservative estimate for the total exports contribution of SMEs lies within the range of 30 to 35 percent.

➤ Export and import licensing

The Export Promotion Bureau (EPB) is attached to the Ministry of Commerce. This department’s main objective is promoting and supporting sustained growth in exports of goods and services in terms of volume and value. It also acts as a registration authority for importers and exporters. Export and import licenses are issued for 5 years, costing PKR 1,500 and PKR 1,530 respectively.

As far as the process of registration is concerned, there are no obvious biases in favor of large firms: the costs of compliance are not high, the procedure is not complex. The decision to obtain registration with EBP solely depends on the need

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to export or import. For this reason, only 12 percent of the entrepreneurs in the SMEDA/Gallup MSE Survey were registered with the EPB. Respondents cited four factors that influenced their decision to register: (1) the license was a government requirement; (2) the entrepreneurs had access to capital; (3) costs of compliance were very reasonable; and (4) the short time spent on registration procedures.

➤ Trade regulations

A wide array of regulations on imports and exports, with a set of procedures to be followed for compliance, have been established in the Customs Act, Sales Tax Act, import and export procedures and quota allocations.

Statutory regulatory orders (SRO) are issued by the Central Board of Revenue (CBR) to implement a policy decision. A full analysis of SROs is beyond the scope of this study but those which formed the basis of certain incentives to promote exports are summarized below in relation to their impact on SMEs.

Due to the short-term orders (one-year) nature of trade policy, a large number of SROs on trade are issued each year. For example, in 2000-01 the number of such procedures issued was more than 25 ___ all containing various amendments to existing systems, as export incentives. It would be difficult to quantify the negative effect of these frequent changes on the performance of SMEs. However, due to lack of awareness, information gaps, low literacy levels and procedural complexities, the SMEs show low utilization of such incentive schemes. The high number of SROs (it can reach 500) is a tremendous obstacle for the SMEs wanting to keep up with the latest SRO schemes and to understand their content.

The general perception of the performance of government departments is very negative. Although some incidences of corruption may be exaggerated, the existence of the problem cannot be denied. Besides the set costs stated in the regulations at each stage, certain additional costs must be incurred, which

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increases the incidence of fixed costs. One example is the import of inputs and raw materials. An importer needs to pay as much as PKR 15,000 per shipment to get the goods cleared from port. If an exporting firm (SME) needs to import inputs under special schemes, it is required to pay additional costs (PKR 5,000 to 7,000) to get the goods cleared from the government authorities. Not only does the importer have to incur these extra costs, but the process of clearing the goods from dry-dock is very complex. From the arrival of the goods, their assessment, evaluation and final clearance, an importer needs to go through 17 steps. The greater the number of steps in a process the higher the additional costs, over and above the set costs the entrepreneur must incur.

In general, the customs tariffs in Pakistan are levied according to the cascading principle. The raw materials are at the lowest end of the value chain so the lowest tariff rates are applied to their imports, while the highest level of tariff is levied on manufactured articles. Since Pakistan is a WTO signatory and the government also pursues a policy of export promotion, the maximum tariff rates are revised each year. It has recently been reduced from 35 to 30 percent.

Tariff reduction and rationalization have a negative and a positive effect on the SME sectors. A case in point is the government's recent reduction in the tariff of steel from 25 to 10 percent. Exporting firms, including SMEs, which use steel as their major input, benefited from this measure. However, for sectors like small melting and steel rolling units, which were operating under tariff protection, such measures lead to the extinction of a sector and to high employment reductions. Numerous factors may come into play in tariff decisions, including international commitments, the strengthening of the economy through market-driven strategies and developing a competitive industry in order to promote exports.

Once decided, customs duty is applied mainly on an *ad valorem* basis, where often the discretionary powers of custom officials come into play. The Customs Department has the authority to evaluate and assess the value of imported goods,

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then apply the relevant duty. This practice gives significant authority to inspectors and appraisers; the matter is resolved through informal negotiations. These factors increase the cost for SMEs because they operate on low consumption; the increase in variable costs is much higher for small enterprises than large-scale operators.

An exporter can claim full refund of all the duties paid during the import of raw material used in the manufacturing of export-oriented items. Duty Draw Back is reimbursed by the government. Rebate is also reimbursed to the exporter as compensation for the duties paid on imported components used in product manufacturing. The rebate rate is determined by the Ministry of Production and Industries, calculated on the amount of imported inputs used to manufacture a particular product.

As most are not direct exporters, SMEs are unable to benefit. It is the medium and large-sized firms and the commercial exporters (which in fact only source the merchandise from local manufacturers) who reap the benefits. Even the small and medium-sized firms that are direct exporters are slightly disadvantaged, because refunds by the CBR are subject to preferential treatment. As the majority of the SMEs are sole proprietorships, they face problems in obtaining their rebate refunds.

In order to protect the industry from subsidized exports and the unfair competition of dumping, the Government of Pakistan has promulgated the Anti-dumping Ordinance. This is a major area of concern for the SMEs as they are highly vulnerable to such scenarios due to their fragmented existence and limited representation in policy-making. Dumping of products by foreign competitors completely undermines the competitive advantage of the domestic product against the imported one.

But law can only act as an effective deterrent when it is backed up with strong monitoring and implementation mechanisms. While the National Tariff

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Commission (NTC) has the authority to take corrective measures, its scope needs to include constant monitoring of trade if it is to provide a level playing field for the SMEs in Pakistan. At present, there is very limited awareness among SMEs about the role of the NTC and its functions as a guardian of the domestic industry.

➤ Exchange rate policies

The exchange rate of the Pakistani rupee (PKR) is determined by the State Bank of Pakistan. Until the early 1990s, the foreign currency and exchange rate regime was under very tight government control. In 1992 the exchange rate was shifted to managed float system and currency trading was also allowed in the open market. Over the last years, the PKR has continuously depreciated against the US dollar.

Although SMEs show various types of flexibility to survive, they can be more vulnerable to certain external shocks such as exchange rate fluctuations, as compared to their large-scale counterparts. In the present era with its inflows and outflows of “hot money” putting pressure (in one direction or the other) on the exchange rate, the risk of damage or death to essentially healthy SMEs (healthy in the sense of their having the potential to be economically productive over a lengthy period) is high.

4.3.4 Enabling and innovative policies

Enabling policies encompass a broad range of incentive programs initiated by the government to achieve development objectives. Historically, these policies have not been targeted to the SMEs sector and, as the following evaluation shows, do not focus sufficiently on the present SME perspective.

➤ Provincial support institutions and small industrial estates

The provincial small industry development organizations established in the early 1970s developed around 46 small industrial estates in the main cities and small-industry clusters across Pakistan to facilitate small enterprise development

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through the provision of subsidized land and infrastructure (roads, sewage facilities, telephone, electricity).

Despite the fact that such projects were set up in all provinces, only a small segment of the SME sector could benefit from these initiatives. First, the focus concentrated on the manufacturing sector and, second, only firms from the upper tier of the small and medium enterprise segment could invest in such industrial undertakings. Nevertheless, programs have proved very beneficial in cluster development and the vast majority of micro enterprises were establishment on the peripheries of these small industrial estates.

In 1972, a Small Industry Corporation was established in each province.

- In the province of Punjab, the Punjab Small Industries Corporation (PSIC) was established as an autonomous body for the promotion and development of small-scale industry in the province. PSIC has developed 14 industrial estates in various areas of the Punjab. PSIC has also launched a “Rural Industrialization Program” to control unemployment and strengthen the household income through the4 stimulation of industrial growth in urban and rural areas of Punjab.
- The Sindh Small Industries Corporation (SSIC) was established to promote small-scale industry in Sindh. The objectives of SSIC include financial assistance through a small-industry credit scheme, the education fo craft workers in product designing and adaptation, a census and survey of cottage and small industries, as well as the procurement and distribution of raw material to craft workers and artisans. The SSIC has established 17 industrial estates in various areas of SINDH province.
- The NWFP Small Industries Development Board (SIDB) is playing a promotional role to support and assist the development of cottage and small

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industry in the province. The SIDB has also launched various Women Development Programs and is also involved in establishing various Model Pilot Projects (e.g. centers for woodworking; for leather goods; wool-spinning; and ceramics). The SIDB has established 9 industrial estates in NWFP province.

- In Baluchistan, the West Pakistan Small Industries Corporation was dissolved in 1972 and the affairs of the small industries sub-sector were assigned to the Directorate of Industries of the Department of Industries, Commerce and Minerals. The Directorate of Small Industries (DSI) was created in 1977 to look after all the promotional schemes for SMEs. The Directorate is also involved in providing various kinds of advisory and consultancy services.

The policy of industrial estate development played an instrumental role in the establishment of small-industry clusters such as sporting goods and surgical instrument manufacturing in Sialkot, cutlery manufacturing in Wazirabad and furniture in Gujrat. In addition, 125 training and service centers provided common processing facilities for industrial projects, training in skills development, and technical and marketing services for entrepreneurs. Until the mid-1980s, under the auspices of the small-industry organizations, these services remained effective.

Two factors were critical to their success: international donor support and professional autonomy. As soon as donor support was withdrawn and political interference became stronger, the standard of service deteriorated. For example, industrial estates established for purely political reasons unviable areas resulted in their remaining essentially unutilized.

➤ Export processing zones: Discrimination or good practice?

With the objective of developing a strong export industry base, the government has established export processing zones (EPZs) in various regions; one such

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facility has started functioning in the city of Karachi. There is no minimum limit of investment in EPZs; an industry can be established regardless of its size, the only condition being that it must export its production. The manufacturing concerns located in an EPZ benefit from duty-free imports of their inputs and the added advantage of reduced interaction with government departments. The responsibility of implementation of labor laws in the EPZ lies solely with the Export Processing Zones Authority (EPZA), relieving the entrepreneur from dealing with a number of labor departments implementing approximately 27 labor laws. The social security levies are also collected by the EPZA, again considerably lessening the time spent in interaction with government departments. On the one hand, this can be viewed as good proactive, by reducing the complexities of compliance with regulations, especially labor laws. On the other hand, it can be considered discrimination against the SMEs not operating in EPZs and unable to benefit from any incentive package that simplifies compliance with regulatory framework.

➤ The Technology Up-gradation Fund

The Ministry of Science and Technology (MoST) has recently taken steps to facilitate the establishment of technology-driven small and medium-sized project. It has introduced a Technology Up-gradation Fund which can also be utilized by existing SMEs for expansion and upgrading of projects. However, similarly to other government development initiatives, the delays in processing destroy the scheme's efficacy: over 700 applications have been received by MoST, but none had been evaluated or approved as of December 2001.

To encourage product standardization and to implement quality systems in the domestic industry, MoST also provides a cash incentive of PKR 150,000 to industries that receive ISO Standards certification. This one-time grant is available to all industries and sectors, regardless of size.

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However, apart from these two initiatives, few specific policy measures are adopted to promote innovation and provide an enabling environment for SMEs. It would be interesting to determine to what extent Pakistan relies for its product improvement and innovation on similar activities taking place in other parts of the developing world.

In the same vein, how effective have past institutional support systems been in nurturing SME development in an undocumented developing economy, and how effective are they at present? The following sections taken a 40-years perspective of the effect of institutional support systems in Pakistan.

4.3.5 Various discrepancies in Policies

➤ Observation on Labor Policy

✓ *Awareness levels*

The foremost problem is the entrepreneurs' lack of awareness of existing labor regulations, which is in direct proportion to the size of the enterprise. The micro enterprises lack basic understanding about the prevailing labor laws. However, they are not required to comply with all regulations. Most enterprises on the threshold between 9 and 10 workers do not find it convenient to obtain basic information on compliance requirements. No consolidated effort has been made by government to inculcate a basic understanding of the labor laws, the steps required for compliance, the rights of owners/managers, or the correlation enforcement with enhanced productivity and improved job quality.

✓ *Understanding the law: Language and literacy*

The Labor Code comprises more than 100 laws, including 30 or so regulations that are not sector-specific and are applicable across-the-board, it is published in English. To fully understand these laws, a comprehensive understanding of the English language is necessary. The literacy rate in Pakistan is as low as 45 percent ("literate" defines those who can write their own name). An urgent step would be to translate the laws into Urdu so as to create wide-scale awareness.

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✓ Complexity of regulations

Entrepreneurs cite the outdatedness of the laws as their main reason for non-compliance, but this is not the case. Despite its title, the Factories ACT, 1934 has been revised and amended at various times to keep pace with developments in fire-fighting equipment or standards related to health. What daunts entrepreneurs is the overwhelming complexity of detail in the regulations and the number necessary steps __ for example, 136 steps are required for compliance with the Factories Act 1934. this is onerous for enterpeises to implement, especially in the start-up phase.

✓ Cost of compliance

The general consensus is that the costs of compliance with labor levies are too high. Yet they are not excessive: for the average SME entrepreneur the total contributions based on various labor levies for an average size SME are not more than 1.5 to 2 percent of annual turnover. However, even if these contributions were made, workers would not benefit greatly, due to dilapidated medical facilities and the limited coverage of pension schemes based on labor levies. Moreover, by entering the formal sector, compliance with labor laws will not be the only issue to deal with. Being part of the documented economy, an enterprise can be traced by various other departments such as the tax department. Thus, many enterprises avoid registering and remain in the informal sector.

✓ Discretionary powers of labor departments

In order to ensure the implementation of laws, government administrative machinery is given certain powers to evaluate and assess the level of compliance within a specific sector. No system can work without an effective implementation mechanism. The problem arises when entrepreneurs have only a limited understanding of their rights, which can result in misuse of power by

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labor department inspectors __ ultimately resolved by directly paying the government official rather than contributing towards the Exchequer.

The perception of entrepreneurs is that the government departments are corrupt and that interface with government officials is problematic. A monitoring system of third-party private-sector compliance auditing would ensure implementation of labor law, at least for the regulations on hiring and the standards of engagement. One law could be tried as a pilot case. Auditing in registered enterprises under the Factories Act, if given to the private sector, could have a positive outcome.

✓ Lagging performance of labor courts

Labor courts were established to help deal with matters pertaining to labor issues. Disputes related to labor departments are also decided by these courts. Due to limited resources, considerable time elapses before cases are finally decided. With almost 10,000 cases pending in the labor courts, it is little wonder that entrepreneurs are reluctant to contest cases against government departments.

✓ Laws and impact on employment

Enterprises with less than 10 workers are exempt from compliance with labor laws, an exemption that acts as a deterrent to switching from the informal to the formal sector. Recently, the government announced a self-assessment scheme procedure to bring into the formal sector those enterprises with 10 or more workers that are still not registered with labor departments. This can only achieve the desired results if the benefits associated with compliance with regulations are propagated effectively nationwide. The commercial aspect and the cost benefit associated with labor levies could serve as a trigger button to facilitate the shift from the informal to the formal sector.

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➤ Observations on the taxation system

✓ *Taxation policies*

Taxation policies in Pakistan are based on short-term measures. When the annual federal budget is announced, numerous amendments in the taxation system form an integral part of the budget provisions. The fragmented nature of small enterprises and their informal-sector location makes it difficult for the government to tailor measures specific to all SME requirements. The solution is to classify enterprises according to the nature of their activities and their size.

At present, tax departments differentiate among enterprises on the basis of annual turnover. Labor laws define enterprises on their number of workers. It would be useful if the definition of SMEs was uniform and standardization for all regulatory purposes, taxation or otherwise.

✓ *Understanding tax policies and procedures: Language and literacy*

Given the low literacy level, the tax procedures and documentation requirements cannot be considered as easy to comply with for a typical micro enterprise. In fact, those micro enterprises that operate in the formal sector, as well as many small and medium-sized enterprises, tend to rely on the help of a lawyer with expertise in tax matters.

✓ *Cost of compliance*

The compliance issue centers on the collection mechanism of the tax authorities and how it empowers them to scrutinize the accounts of enterprises as and when desired. Micro and small businesses not operating as companies have a lack of qualified accounting systems and a lack of understanding of the regulatory framework. This increases their difficulties in dealing with government officials and leaves them more open to harassment. In turn, it is the inability of the micro and small enterprise to meet the standard requirements of the law that increases their vulnerability.

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✓ Tax culture, transparency and government performance

Developed countries have higher tax rates as well as a high number of tax payers because they have a tax culture that is based on transparency in government expenditures and the benefits offered through public welfare programs and infrastructure development. The lack of a tax culture in Pakistan, where the ratio of direct taxes to GDP is as low as 4 percent, is reflected in government performance. The high level of non-development expenditures and lack of transparency in government spending is similarly reflected in the population's unwillingness or inability to contribute to the notional exchequer.

✓ Government efforts to document the national economy

In an effort to broaden the tax net and bring the undocumented economy into the formal sector, the government has launched a major documentation campaign for tax purposes in 13 major cities. This tax survey is being conducted under the "Survey for Documentation of the Economy Ordinance 2000". Initially, it targets urban areas where the business community is comparatively familiar with the regulatory framework (compared with rural areas). The unfamiliarity of the micro and small enterprises operating in the informal sector and their negative perceptions of the discretionary powers given to the officials involved in the survey process remains a problem. These officials have power to arrest individuals they consider to be withholding the information requested.

Another weakness in the process is that before initiating the survey, no educational or awareness campaign for the business community was conducted. Had the tax departments done so, it would have enhanced understanding on the tax regulations. The tax authorities focused only on meeting their targets, ignoring the need to improve the perceptions of and relationship between taxpayer and tax collector.

✓ Delays in processing

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A salient feature of numerous tax departments is the prolonged delays in processing refunds. Sales tax authorities, for their convenience, discriminated on the basis of enterprise size. The “Gold” category of companies registered under the Companies’ Ordinance, with audited accounts, has the highest chances of getting refunds processed. The “Silver” category, although it does not require an enterprise to be registered as a company, does require them to submit a bank certificate indicating a loan limit four times the total amount of the refund claimed. The micro and small enterprise category cannot benefit from government incentive systems and wait extended periods to get their refunds processed. Even then, certain fixed rates (speed money) over and above the actual costs have to be paid. For the micro and small enterprises, already financially starved, such bottlenecks and refund delays place undue pressure on their cash flows.

➤ Observations on trade policy and regulations

✓ *Process of trade policy formulation*

Although trade policy decisions impact negatively on the SMEs in the manufacturing sector, they have no representation in the policy-making process. Large-scale enterprises, strongly represented by key industry and trade associations, dominate the smaller players who do not realize the importance of trade associations in protecting the rights of a given sector. Further, SMEs in general are not recognized in the formulation of trade policy.

✓ *Inconsistency in policy measures*

The government is often blamed for being inconsistent with its policy initiatives and rightly so. One particular phenomenon within the CBR is the Statutory Regulatory Orders (SROs), which are issued whenever a new procedure is introduced or an existing procedure is modified for export and import purposes. It is never easy to forecast the life of a policy measure announced in a trade policy. One example is the tariff rate on accessories (buttons and zippers) used in the manufacture of textile and leather garments. Before the announcement of

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Trade Policy 2000, the import duty on accessories was completely abolished. Three months later, the government levied the same duty rate of 35 percent on imports of accessories (buttons and zippers) used in the manufacturing of textile and leather garments. Before the announcement of Trade Policy 2000, the import duty on accessories was completely abolished. Three months later, the government levied the same duty rate of 35 percent on imports of accessories. This kind of measure undermines the performance of the SME sector by distorting their cost structures. There have also been instances where company-specific SROs were issued, solely benefiting one firm and completely ignoring the impact on the overall industry, particularly the SMEs.

✓ Limited benefits to indirect exporters (SMEs)

Micro and small enterprises form the backbone of direct exporting firms, as they supply the finished components and semi-finished products. Due to their lack of awareness about international markets, their connectivity to international buyers, and their inability to directly tap export markets, the SMEs working as indirect exporters. Examples include:

- **Rebates and indirect exporters:** A fixed percentage of the total export value of products is reimbursed to the direct exporter by the government. The basic intention is to make the domestic products competitive through compensation against duties and taxes paid in import of inputs. Even if a commercial exporter is involved, rebate is claimed by the commercial exporter, whereas the process vendor (SME) who has actually manufactured the product by using various inputs receives no rebate. Clearly, export development policies are more in favor of commercial exporters than the actual manufacturer or process vendor.
- **Tax benefit and indirect exporters:** Similarly, and regardless of their size, those units exporting 80 percent or more of their total production do not need to file income tax returns. All their remittances reach the respective banks/financial institutions where a tax based on total turnover ranging from 0.5 percent to 1.5 percent is deducted at source. This particular

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incentive saves the exporters from dealing with the complex procedures involved in the filing and computation of income tax returns. In practice, a large number of micro and small sized process vendors perform various processes for direct exporters but the benefit of lesser documentation and lower tax collection is not transferred to these small vendors. Even if the 100 percent capacity of a small process vendor is dedicated to manufacturing for direct exporters, the vendor would still be required to maintain books and records, compute its income and tax liability and then file the income tax returns on an annual basis.

✓ Incentives for exports

In order to promote exports, the government has offered various incentives packages favor large-scale sector. Various incentive packages favor large-scale firms. One example, the SRO 71(1)95, provides complete waiver of customs duty and sales tax on the imports of inputs depending on firm size (employing 100 workers). This effectively bars enterprises in the micro, small and medium categories from benefiting from this incentive package. It is however worth mentioning that this SRO is meant for firms in the special industrial zones (in which there is no bar on the establishment of firms based on size). Again, this is an obvious policy bias in favor of large-scale firms.

Other similar incentives schemes, such as No Duty Drawback (NDND) and Manufacturing in Bond (MiB) are related to temporary imports of inputs for exports and, by default, are not devised for use by small enterprises. First, the small enterprises are unable to establish separate warehouses in order to meet the requirements of MiB and, second, they are unable to generate the volumes which would make NDND viable for them.

✓ One-window facility for exporting firms in EPZs

One obvious discrimination between the firms operating in international markets and the firms operating in the domestic market, is the facility of a one-

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window operation to pay government levies. Firms operating in Export Processing Zones (EPZs) are not required to deal with individual labor departments to pay social security, employees old-age benefit contributions, etc. The Export Processing Zones Authority is responsible for the implementation of labor laws and collection of levies from firms located in EPZs. Firms operating in domestic markets have no such facility or incentive available and must deal with all the departments separately. The collection of labor levies under so many diverse regulations is a drain on entrepreneurs' productive time.

✓ Policy-making and international compliance requirements

In Pakistan, on the one hand, the government has committed to withdraw the protection given to the local small-scale vendor industry according to WTO but, on the other hand, the local vendor industry that manufactures parts and components for large industries has not been given any opportunity to restructure itself to deal with the demands of globalization. A sudden removal of protection will not only result in making these small ventures sick but will also significantly reduce employment.

Such gaps in policy-making and the short-term development approach they generate raise apprehensions about the investment climate in Pakistan and prove negative for the small and medium-sized enterprises, unable to adjust to frequent changes in the policy environment.

✓ Evident barriers for SMEs

The importance of the textiles sector and its relevance to and for the SMEs needs no further emphasis. Nevertheless, policy measures exist which act as barriers to SME growth and even to their entry in the textiles and apparel sector. The culprit here is quota policy. Without any special provisions for quota allocation to potential and new investors, only large-scale firms with financial muscle are able to further grow and expand in the international

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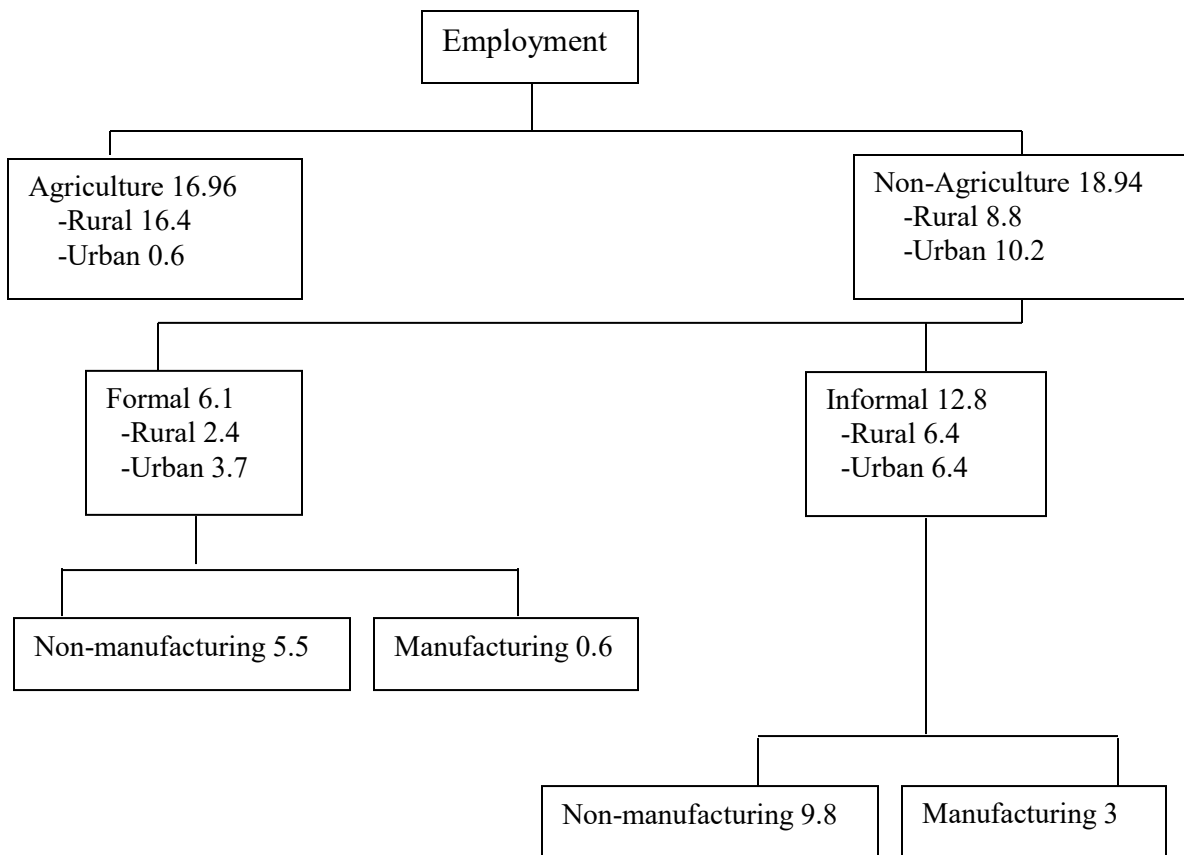
markets. In India and Indonesia, for example, a certain proportion of total quota is allocated to new and potential investors. This ensures the provision of a level playing field for all investors, regardless of their size.

4.4 Economic Significance of SMEs in Pakistan

4.4.1 Employment statistics according to various sources

It should be stressed at the outset that wide discrepancies exist between various data sources on total labor force estimates for Pakistan. Figure (shown below) maps the sectoral distribution of employment according to the 1997-98 Labor Force Survey (LFS) data, with the total employed labor force estimated at 35.9 million.

Figure: Employment distribution in Pakistan, 1997-98 (millions)



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Source: Labor Force Survey, 1997-98

The share of the non-agriculture sector is 53 percent. Further disaggregation of data is done on the basis of formal and informal sector. 'Informal' is defined as comprising those establishments that are not registered with any government department or agency. All establishments of less than 10 workers fall under this definition given that they are not required to register under labor law. Almost 68 percent of non-agricultural employment is estimated to be the informal sector ___ indicating that the majority of establishments in the non-agriculture sector are micro enterprises.

According to the Census of Manufacturing Industries 1995-96, total employment in the formal manufacturing sector is 0.6 million (or 10 percent of the total formal non-agriculture sector employment). The remaining employment in the formal non-agricultural sector is absorbed by the trade and services sectors, as estimated by the LFS data, 1997-98.

Employment in the informal manufacturing sector may be estimated at 3 million persons, with a share of 23 percent of the total employment in the informal non-agricultural sector. Thus, 77 percent of non-agricultural informal employment is being generated by micro enterprises in the services and trade sectors.

An example of the differences in various data sources on total labor force is the above-mentioned estimate of 3 million for total informal manufacturing sector (micro enterprises) employment, using LFS and CMI data. According to the Survey of Household and Manufacturing Industries, 1995-96 (SHMI), which covers informal sector enterprises, the total employment is around 1.26 million ___ a discrepancy of 1.74 million, owing to varying methodologies, coverage and scopes in these surveys. Nevertheless, it is important to attempt an estimate of the share of SMEs in total employment activity.

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The Census of Establishments estimated the number of establishments at slightly above 2 million, providing employment to 5.66 million workers. It furnishes significant information on the role of micro enterprises and their employment-generating capability. As shown in the figures below, 97% of the establishments surveyed were micro enterprises (less than 10 workers) and provided employment to almost 60% of the population

Figure: Distribution of employment by unit (establishment) size classes

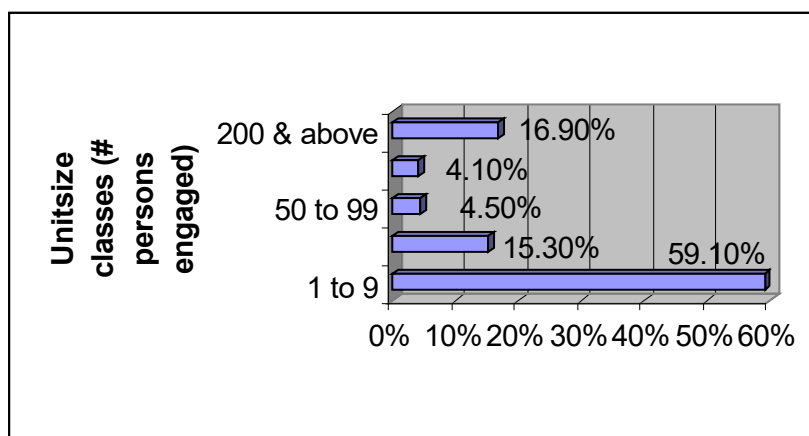


Figure: Distribution of units according to size classes

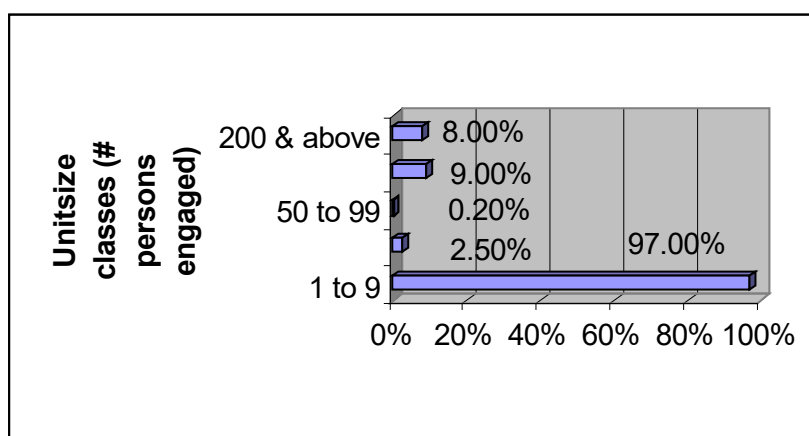


Table: Estimated employment in the SME sector, 1997-98

Manufacturing Sector

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Micro	875,449	11.8%
Small	439,044	5.9%
Medium	112,217	1.5%
Total	1,426,710	19.2%
Trade		
Micro	2,014,489	27.2%
Small	45,664	0.6%
Medium	5,056	0.1%
Total	2,065,208	27.8%
Services		
Micro	1,508,796	20.3%
Small	584,124	7.9%
Medium	205,383	2.8%
Total	2,298,303	31.0%
Overall employment		
SMEs	5,790,221	78.1%
Large-scale employment	1,624,662	21.9%
Total estimated employment	7,414,883	

Note: Micro enterprises are defined here as less than 10 persons engaged; small units as 10 to 49 persons engaged, and medium units as 50 to 99 persons engaged.

Source: SMEDA based on the Census of Establishment 1988.

4.4.2 Employment analysis by sector

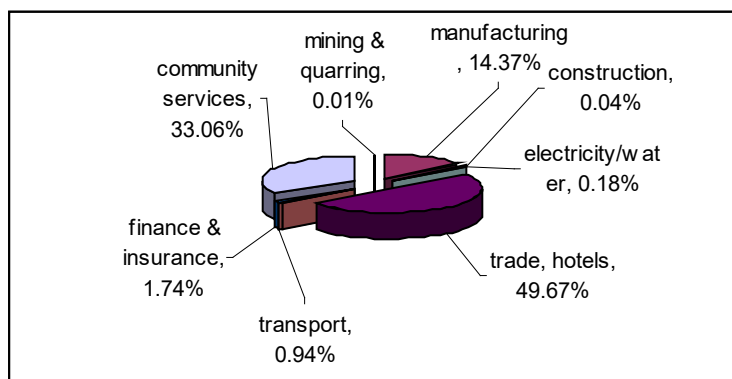
To develop a profile of the SMEs in Pakistan and their employment contribution by economic sector, existing secondary data sources were analyzed. They provided fragmented and inconsistent information. Most available data deal only with the manufacturing sector. The trade and services sectors are surveyed in the Census of Establishments, which has been conducted only once, in 1988.

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➤ Overview

As figure shows, the highest concentration of units (49.67 %) is in the trade/hotel sector, which includes enterprises in retail or wholesale trade, restaurants and hotels. The community services sector represents a share of 33 percent of the total number of units.

Figure: Sectoral distribution of units, 1988



The community services sector contributes almost 39 percent of the employment total; the manufacturing sector almost 28 percent, according to the 1988 Census of Establishment data presented table below. The trade/hotel sector dominates the overall number of units and provides employment to 27 percent of the total employment, by reason of its high concentration of micro-sized units. The employment contribution of the other sectors is relatively negligible.

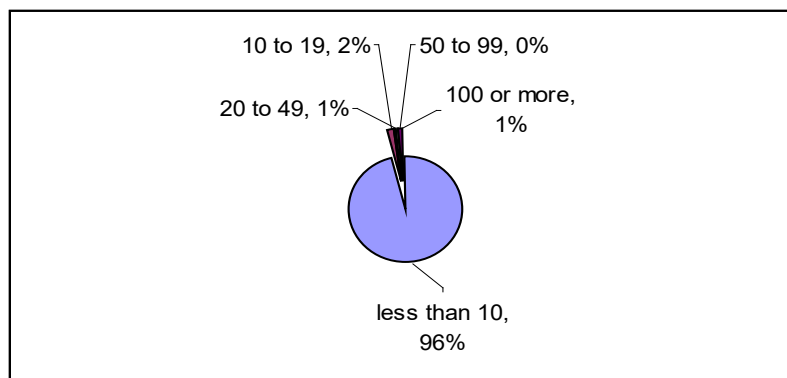
Table: Sectoral distribution of employment, 1988

Employment	Mining & Quarrying	Manufacturing	Electricity/ Water	Construction	Trade, Hotels	Transport	Finance & Insurance	Community services
Total	16,432	1,622,663	19,300	4,671	1,548,134	74,151	199,602	2,237,234
Share in								

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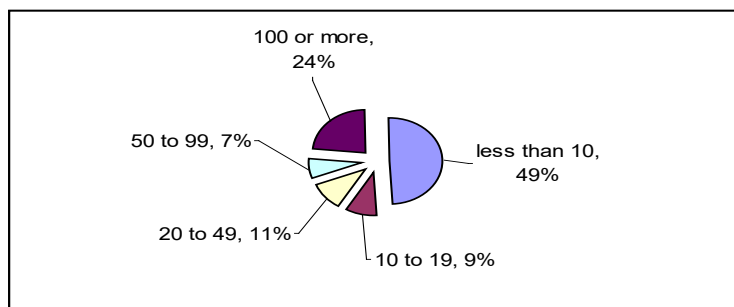
employment (%)	0.3	28.4	0.3	0.1	27.1	1.3	3.5	39.1
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Figure: Distribution on employment by unit size classes in the trade/hotel sector, 1988



Source: Census of Establishments, 1988

Figure: Distribution of employment by unit size classes in the community services sector, 1988



Source: Census of Establishment, 1988

Figures show the distribution of employment by unit sizes and the significance of micro enterprises in the two largest trade and services sectors. In the trade/hotel sector, almost 96 percent of employment is generated by enterprises with less than 10 persons engaged. Average employment per unit is only 1.5, reflecting a high presence of self-employed workers who operate a retail stall or food outlet, often in the local markets. In the community services sector, the highest contribution to employment is from units with less than ten workers __ a share of almost 50

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percent of the employment total. A 24 percent employment share is generated by enterprises with more than 100 workers in large-scale public and private sector establishments. The average employment per unit in the community services sector is 3.4, considerably higher than trade/hotel sector average of 1.5.

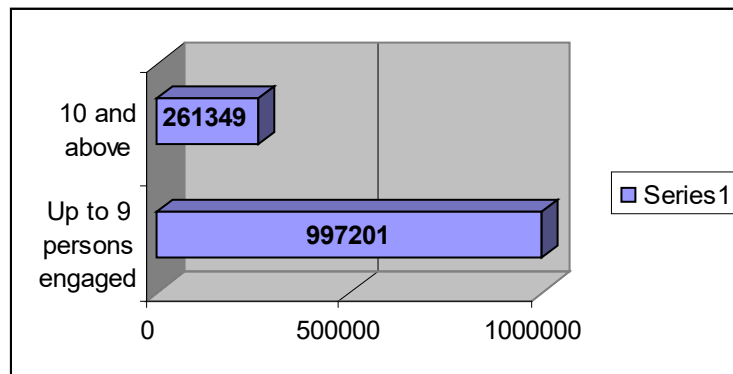
➤ Formal and informal SME employment in the manufacturing sector

A considerable amount of information is available on the manufacturing sector. The Survey of Small and Household Manufacturing Industries (SHMI) provide useful insights into informal sector employment. Data on the manufacturing industries operating in the formal sector are available from the Census of Manufacturing Industries (CMI), 1995-96.

✓ *Informal (unregistered) SMEs in the manufacturing sector*

According to the SHMI 1996-97 data, total employment in informal-sector manufacturing enterprises is around 1.26 million. Approximately 428,000 household and small manufacturing units are operating in the informal manufacturing sector.

Figure: Number of workers in informal manufacturing units, 1996-97



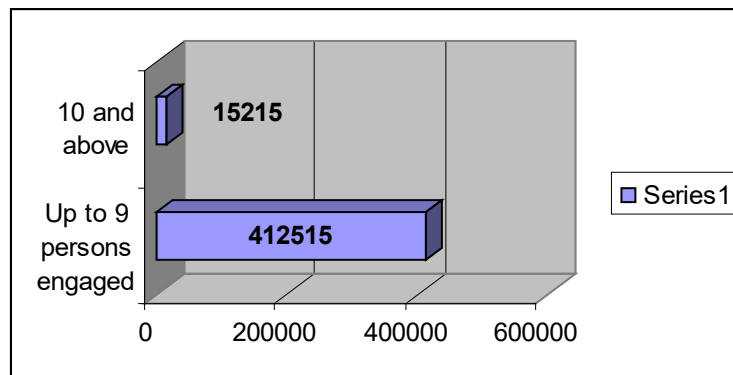
Survey: Survey of Small and Household Manufacturing Industries, 1996-97

Almost 60 percent of these units are located in rural areas: this high concentration is consistent with the population pattern of Pakistan. An

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interesting feature of the SHMI data in figure is its estimate of 15,215 units, employing ten or more individuals in the informal sector. With average employment per unit estimated at 17.4, this implies that a high proportion of employment is generated by small enterprises that are not registered, despite employing ten or more workers. The value-added contribution of informal sector firms is 7.8 percent of the total manufacturing value-added of Pakistan.

Figure: Number of units in the informal manufacturing sector, 1996-97

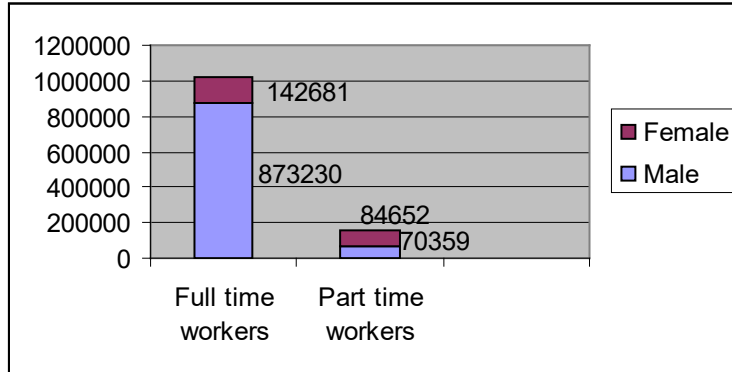


Survey: Survey of Small and Household Manufacturing Industries, 1996-97

Men workers (83 percent of total employment) and full-timers (81 percent of total employment) dominate the informal manufacturing sector. The share of women workers in the formal sector is very small. Almost 37 percent of women workers are employed part-time compared with only 8 percent of men workers.

Figure: Distribution of full-time and part-time workers in the informal manufacturing sector, according to sex, Pakistan, 1996-97

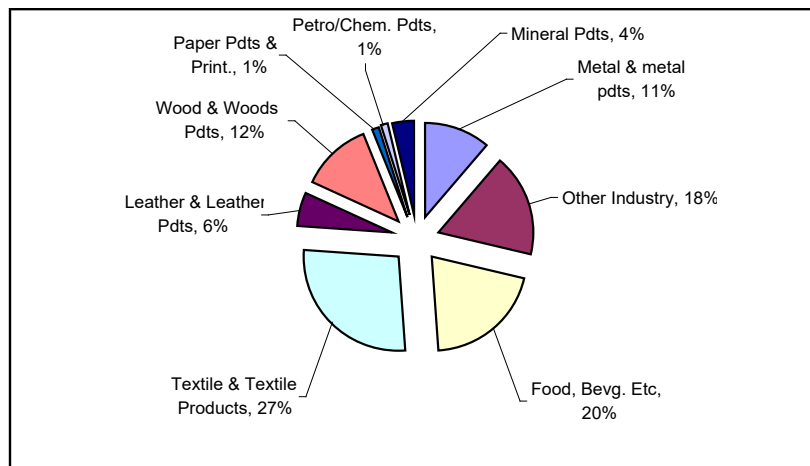
Impact and Role of Small and Medium-Size Enterprises on the Economic Development of Pakistan



Survey: Survey of Small and Household Manufacturing Industries, 1996-97

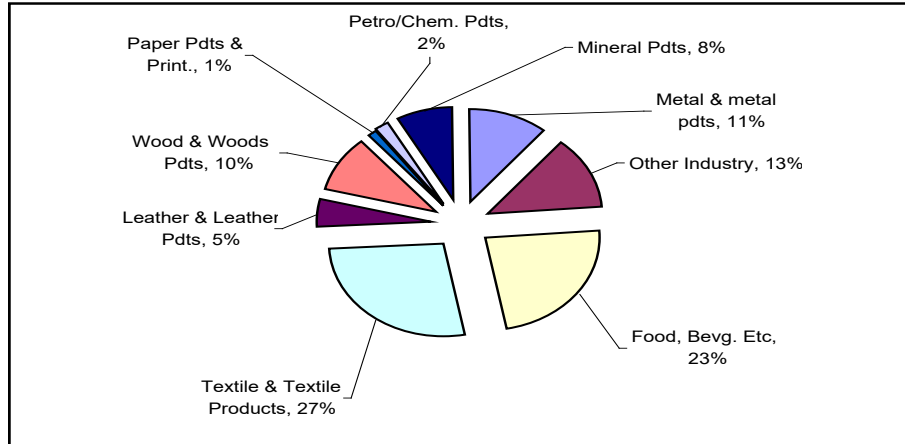
The textile sector is the most important economic activity in the informal manufacturing sector, both in terms of number of units (almost 27 percent of the total units) and employment contribution (27 percent of the total employed in the informal manufacturing sector). This includes activities such as small-scale spinning of cotton yarn, dyeing and weaving of fabric and apparel stitching. Other significant sectors include metal products manufacturing, food and beverage products, mineral products and wooden products.

Figure: informal manufacturing units by sector, 1996-97



Survey: Survey of Small and Household Manufacturing Industries, 1996-97

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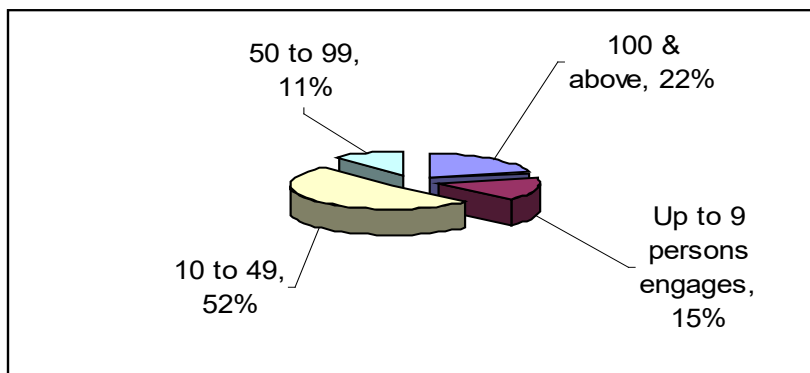


Survey: Survey of *Small and Household Manufacturing Industries, 1996-97*

✓ ***Formal (registered) SMEs in the manufacturing sector***

The Census of manufacturing Industries conducted in 1995-96 provides information on the manufacturing concerns operating in the formal sector. This survey reported the total number of manufacturing concerns is only 4,474. Most units are concentrated in the segment employing 10 to 49 persons. Almost 84 percent of the total employment is generated by formal-sector manufacturing units employing more than 100 persons. The SMEs constitute 78 percent of the total number of manufacturing units in the formal sector, whereas the total employment created by these units is only 16 percent of total formal-sector employment. On this basis, estimated employment in the informal and the formal manufacturing sector SMEs accounts for 1.35 million workers.

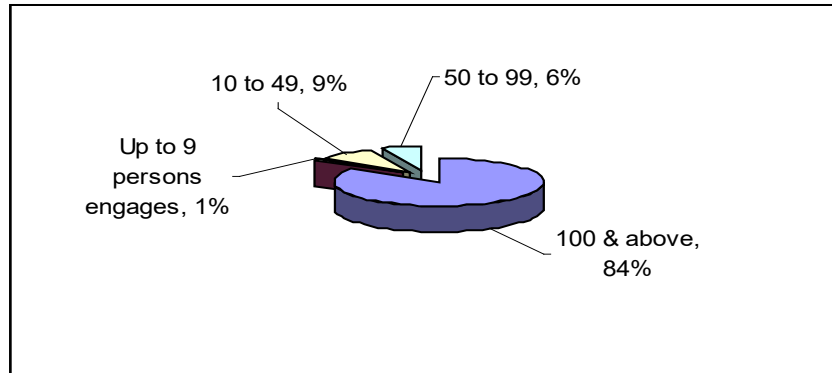
Figure: Formal manufacturing establishments by size



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Source: Census of Manufacturing Industries, 1995-96

Figure: Formal manufacturing employment by establishment size, 1995-96



Source: Census of Manufacturing Industries, 1995-96

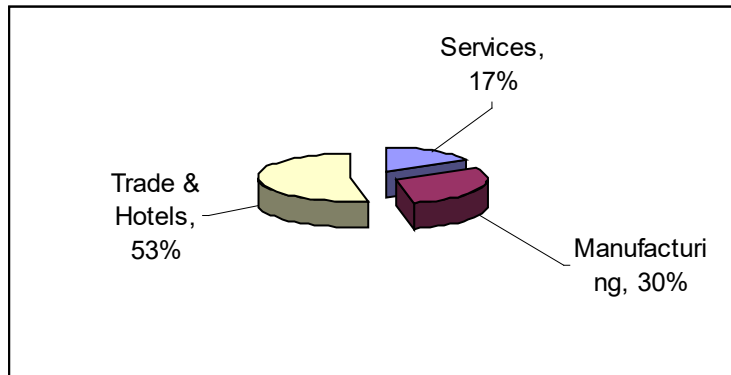
4.4.3 GDP and the SME sector

The SMEs sector in Pakistan is characterized by a high presence of micro enterprises. More than 95 percent of these enterprises, regardless of sector, operate at the micro level (employing less than 10 workers). And, as micro enterprises are dominated by self-employed individual entrepreneurs, a main feature of these enterprises is their very small contribution to GDP. However, it must be determined the presence of SMEs accurately. The difficulty is compounded by the varying methodologies used by surveys to determine the contribution of SMEs to GDP.

To estimate the total contribution of SMEs to GDP, three data sources have analyzed. The CMI 1990-91 is used to estimate the contribution of formal manufacturing sector micro, small, and medium-sized enterprises. The SHMI 1996-97 is used for that of the informal manufacturing sector firms (micro and small) and the ISSMI 1992-93 is used for the service and trade/hotel sectors. As some of the data is as old as 1990-91, the contributions to GDP for 2001-2002 have been estimated by extrapolation. Based on these estimates, figure below presents the distribution of SMEs GDP by sector.

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Figure: Distribution of estimated SME GDP by sector, 2001-2002

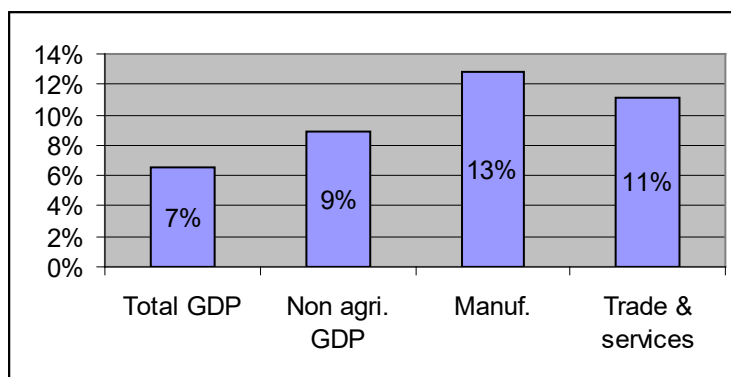


Note: services include transport, finance and community services.

Source: *SMEDA, 2002*

The SME sector contributes around 7 percent of the GDP, and 9 percent of non-agricultural GDP. This low share is explained by the dominant presence of micro enterprises in all three sectors. Although the contribution of SMEs to total GDP is not very high, it still represents almost 13 percent for the manufacturing sector and 11 percent for the trade and services sector.

Figure: Estimated SMEs' contribution to GDP by sector, 2001-2002



Source: *SMEDA*

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Some studies have estimated the share of SMEs in GDP at a much higher level. In this context. It is interesting to note that it has recently been estimated that the “undocumented economy” accounts for 55 percent of enterprises covered and the varying results obtained in surveys, figures on the share of SMEs in GDP may be either under- or overestimated.

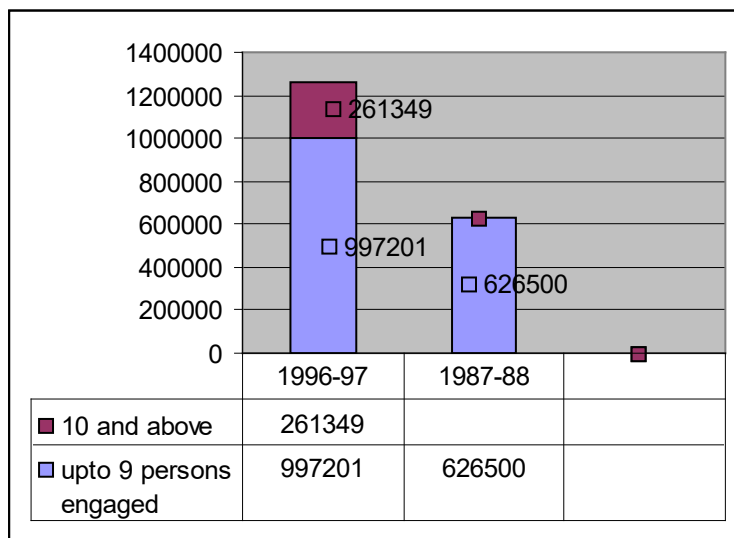
Given the current stage of development in Pakistan and present indications, the key driver is rapid employment creation with low levels of investment. A keynote of the SMEs sector is its employment-generating capacity.

4.4.4 Trends of employment in SMEs

The growth of employment in manufacturing micro enterprises in Pakistan can be estimated using the findings of the Survey of Small and Household Manufacturing Industries (SHMI) conducted in 1987-88 and 1996-97. According to SHMI data employment in micro enterprises increased by almost 60 percent (from 627,000 to almost 1 million persons) over this 10- year span, with a similar growth (also 60 percent) in the number of enterprises. Unfortunately, there are no data available on the employment growth in small and medium-sized enterprises, or in SMEs in the trade and services sectors. In addition, due to the absence of longitudinal data set by enterprise size, the actual employment creation in SMEs cannot be estimated.

Figure: Workers in informal manufacturing enterprises by size class, 1987-88 and 1996-97

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Source: Survey of Small household and Manufacturing Industries, 1987-88; 1996-97

Gallup carried out a small-scale survey in 2001 to capture the most recent pattern of employment growth in selected SMEs. Table below shows that 36 percent of the surveyed enterprises increased their number of workers; 43 percent neither increased not decreased their workforce; and 14 percent decreased their workforce.

Table: Employment growth in surveyed SMEs, 1999-2001

	Permanent full-time (%)	Permanent part-time (%)	Temporary (%)	Total (%)
Micro	7.4	20.2	22.7	12.8
Small	18.5	0.0	25.0	17.5
Medium	25.0	-	-100.0	0.0
Total	16.3	9.3	7.8	13.7

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Growth rates of the average employment in enterprise size classes

In terms of the actual number of employees, the total increase from 1999 to 2001 was 14 percent. The highest increase (18 percent) was in small enterprises, mainly due to an increase in the number of temporary employees. Employment in micro enterprises also increased through a balanced increase in part-time and temporary employees. In medium enterprises, the employment level remained stagnant, due to a drastic decrease in temporary employment. However, permanent full-time employment in medium firms increased by almost 25 percent.

4.4.5 Employment management and enterprise practice

Most employees in the SMEs sector are employed full-time. According to the SMEDA/Gallup MSE Survey, more than 60 percent of micro and small enterprise workers and 100 percent of workers in medium enterprises were employed full time. Reliance on temporary employees was found to be very restricted in micro and small firms. In the medium-sized firms surveyed, no employees worked on a part-time or a temporary basis.

The low participation of women in the SMEs sector is similar to the gender picture for the total labor force of Pakistan. Female employment was almost 17 percent of total employment in the enterprises surveyed by Gallup. A large majority of enterprises employ no women: 76 percent of the sample had no permanent full-time female employees. The percentages for part-time and temporary employment for women were even higher, at 94 and 97 percent respectively. The reasons for low female employment in the SMEs are not very different from women's low participation in overall economic activity. Due to prevailing socio-cultural norms, women in most parts of Pakistan are discouraged from working formally in industrial, trade and services sector activities.

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Table: Conditions of work or benefits provided by SMEs to workers (%)

Provision	Total	Sector			Enterprise size		
		Trade	Services	Manufacturing	Micro	Small	Medium
Drinking-water facilities	76	65	77	87	66	83	95
Safer working conditions	72	65	71	80	63	78	90
Salary increase	66	53	66	79	51	78	92
Toilet facilities	62	43	69	71	48	70	92
Productivity incentive	56	41	57	67	39	72	74
On-the-job training	38	16	44	52	30	47	44
Written contracts of employment	20	12	19	28	6	31	44
Transport for workers	16	9	19	21	5	24	38
Maternity/paternity leave	15	2	26	15	8	21	26
Off-the-job training	9	1	14	12	2	17	13
Pension/insurance scheme	8	2	6	16	1	12	26

Table indicates the overall conditions in which workers operate in Pakistan, including work environment, remuneration, social coverage such as pension and insurance, and job security. The practice of written contracts of employment in the SMEs surveyed by Gallup is rate: only 20 percent of respondents provide employees with this type of contract, mainly in medium-sized enterprises which are also registered with the labor department. In the micro sector, enterprise owners generally employ on verbal contracts, with only 6 percent providing contracts in writing. Employee pension or insurance schemes are also very low; only 8% of respondents provided any social coverage or benefits.

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On the other hand, there is wider provision of salary increases, sager working conditions and productivity incentives. It would be incorrect to assume that the salary increase is a norm in this highly competitive sector. Monetary benefits are strictly tied to performance and productivity. The SMEDA/Gallup MSE Survey found that almost 56 percent of enterprises in the SMEs sector provided a productivity incentive to employees.

It is generally assumed that human resource development in SMEs is through the system of Ustaad-Shagird (apprenticeship); young apprentices are employed on meager salaries but provided with on-the-job training. However, according to the SMEDA/Gallup results, very few apprentices are hired (no apprentices) were reported in small and medium enterprises, with a negligible proportion hired in micro enterprises. Equally, off-the-job training is rarely provided to employees.

An important aspect of conditions of work is observance of the labor code, which clearly states that the working hours should not exceed 8 hours a day. In SMEs sector, the average shift worked is 12 hours. Employees are not paid overtime as salaries are based on a 12-hour norm.

It is generally assumed that the majority of SMEs owners/managers has little formal education and acquires their skills or know-how in a family-owned or operated business. However, according to Gallup survey, only 4 percent of respondents had no formal education; 38 percent had university education and 35 percent had post-secondary education. Only 3 percent of respondents had received any vocational training. Interestingly, the number of women entrepreneurs with university education was much higher than that of men entrepreneurs.

Table: Type of business initiatives taken, according to enterprise size (%)

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How your business started	Total	Enterprise size		
		Micro	Small	Medium
As a family-owned business	22	19	24	26
On my own initiative	61	67	55	54
Friend or relative	14	10	17	21
Bought as running business	3	4	2	0
No response	1	1	1	0

As table shows, only 22 percent of respondents had entered family-owned or operated enterprises. The vast majority were start-ups (67 percent of respondents had started their own micro enterprises in the SMEDA/Gallup MSE Survey). Family-owned businesses were also operating in the sector but only to limited degree. Women entrepreneurs (83 percent of respondents) established a start-up based on their own independent decision, which is significantly higher than the number of men respondents. This could result from a sampling bias favoring women from urban areas, who enjoy considerable economic independence to take business initiatives, in comparison with the large majority of women in rural areas.

In most developing countries unemployment and poverty are major factors in business start-up, particularly in micro enterprises __ commonly known as “survivalist enterprises”. Individuals managing these businesses immediately switch as soon as they find better opportunities. The majority (68 percent) of respondents to the Survey stated that their main motivation to start a business was that they “wanted to be their own boss”, with the highest proportion of these respondents were in micro enterprises. Only a very small number of respondents stated that they had started their business because they were indication that the entrepreneurial spirit may be a basic motivator in the initiative and risk-taking involved in business start-up.

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Household enterprises constitute a significant proportion of micro and small enterprises in Pakistan. According to the SHMI 1996-97 data, of total of more than 400,000 micro-level manufacturing establishments, 38 percent of enterprises operated a sole business site and 33 percent shared a business site. Only 12 percent of enterprises operated a sole business site and 33 percent shared a business was high in micro enterprises (20 percent) and in enterprises managed by women (35 percent). These results are consistent with the SHMI estimates. The data imply that, for the majority of owners or managers of SMEs, their business is their source of income and cannot be considered as a side business. In the majority of enterprises surveyed, the entrepreneur owns the premises in which the business operates (62 percent of medium enterprises, 57 percent of small and 44 percent of micro enterprises). This suggests that as the enterprises grow in size and acquire a formal structure, they use their increased financial resources to build up capital investments and assets.

In sum, the characteristics described above indicate that the SMEs are fully functional, independent business entities generating full-time employment. There is evidence that these enterprises, like the large-scale firms, experience growth. Employment for women is extremely low in these enterprises, but this is not exclusively associated with the SME sector; female labor force participation at a national level presents a dismal picture. Depending upon resources, the SME labor force is managed by the performance/reward incentive system. Employees do not enjoy the benefits of job security in the form of formal contracts or the benefit of social security but, given their resources, employers try to provide a safer working environment. The SMEDA/Gallup MSE Survey found that, in most cases, respondents had initiated and operated their enterprises with well-devised methods of respondents had initiated and operated their enterprises with well-devised methods of planning __ in their initial response to market demand and also from their wish to “remain their own boss”.

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4.4.6 SMEs and Poverty Alleviation

- More than 12 million people were added to the poor in Pakistan between 1993 and 1999. The rising poverty was the result of poor governance and slow economic growth. The government, NGOs and private sector are implementing programs aimed at improving governance and accountability of public institutions to be able to better respond to the needs of the poor, assisting them economically through creating income and employment opportunities, and improving their access to better services.
- Employment creation is one of the most viable ways of reducing poverty levels in the country. This wins SMEs an important place in the economy since the declining growth of agricultural and large scale manufacturing (LSM) sector has crippled their abilities to absorb Pakistan's surplus labor. The capital to labor ratio in the SME sector is around one-fourth that for LSM industries. Thus SMEs also need less level of investment per job created, offering a rather inexpensive way of accommodating excess labor in the rural and urban areas alike. SMEs thus become a tool of equitable wealth distribution through out the country. If approached strategically, millions of jobs could be created in the five key sectors of textile, leather, dairy, marble and fisheries.

The interim PRSP (Poverty Reduction Strategy Paper) highlights the importance of pro-poor growth led by the private sector especially through SMEs. The Strategy has identified four sectors, namely agriculture, SMEs, IT (information technology) and energy (gas and coal). These sectors are generally labor intensive and their development will eventually lead to job creation.

4.5 Country analysis

4.5.1 Indian SMEs

- **Introduction**

Impact and Role of Small and Medium-Size Enterprises on the Economic Development of Pakistan

The small-scale industries (SSI) sector plays a significant role in the Indian economy. For the past one decade, it has been consistently registering about three per cent higher real growth rate (8.9 per cent during 1999–2000) compared to the growth recorded by the industrial sector as a whole. With about 3.4 million registered SSI units in the organized sector, the sector is the second largest employer, after agriculture. At the end of March 2000, it employed about 19 million persons. The SSI sector contributes over 41 per cent of the total industrial production, 31 per cent of the country's total exports, and jointly with traditional industries (such as Khadi, village, handloom, handicrafts, sericulture, and coir) the relative percentage goes up to 58 per cent.

Small and medium enterprises are defined differently world over on the basis of quantitative parameters such as (1) number of employees, (2) annual turn over, or (3) fixed investment.

In India the small scale sector is defined in terms of the value of investment made in the plant and machinery based on the original value.

An industrial undertaking in which the investment in fixed assets in plant and machinery held on ownership terms or on lease or on hire-purchase does not exceed Rs. 100 lakh (Indian Rupees one hundred lakh only)

Rs. 100 lakh = US \$217,391 at the exchange rate of US \$1 = Rs. 46

For tiny enterprise an industrial undertaking in which the investment in plant and machinery is only 25 lakh, (US \$ 54,350) irrespective of location.

For small scale service and business (industry related) enterprises industry related service and business enterprises with investment in fixed assets, excluding land and building up to 5 lakh (US \$ 10,870) irrespective of location.

Small Scale Industry (SSI) sector in India contributes a significant share to the national economy. The contribution from SSI sector GDP at present is around 7%.

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95% of the industrial enterprises in India belong to SSI sector and 40 % of the total industrial output is from SSI sector. 45% of the industrial employment in India is in SSI sector. Next to agriculture, SSI sector is the largest provider of employment. Contribution from SSI sector to the total exports from India is 35%.

So the scenario of SMEs in India is like

- In India SMEs play a vital role in generating employment, getting export earnings, etc.
- Contribute around 40% of manufacturing sector and 35% of the total exports.
- Low level of investments, cost competitiveness
- Low capital base, Limited managerial manpower,
- Inadequate exposure to international market
- Inability to invest in R & D.
- Those having strong technological base can stand in international market given an open environment with lesser control on industry.

About small scale units

- Though some of them are successful in domestic markets had neither well-designed organization nor any specific plan for future.
- 50% of them did not exude a confidence to transfer of technology related to their product.
- Also not articulate regarding the price of technology.
- All the SMEs showed a preference for African countries particularly Republic of South Africa.
- No willingness for The Republics of Central Asia due to lack of knowledge.

The statistics of Small Scale Industries in India in terms of number of units, production, employment and exports during the last decade are given in table 1.

➤ Policy changes

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In order to sustain the pre-eminent position of the SSI sector in India, the government, the Reserve Bank of India (central bank), DFIs and commercial banks have been taking proactive steps and effecting changes in their policies to meet the new challenges posed by the liberalized economic policies and the WTO regime.

➤ **Finance**

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Traditionally, India has two sets of financial institutions for assistance to the SSI sector (a) commercial banks which mainly provide short-term working capital and (b) DFIs which extend long-term credit for capital investments. Of late, the cooperative banks have also started giving short-term loans to micro enterprises and the rural non-farm sector primarily in the rural areas. While the SSI sector has gained considerably from liberalization, with about 18 per cent of its share in the total of net bank credit, finance particularly short-term credit continues to be a

Year	No. of Units (million)	Production		Exports		Employment (million Nos)
		In billion Rupees	In billion US \$	In billion Rupees	In billion US \$	
1990-91	1.94	1553.4	33.78	96.64	2.10	12.53
1991-92	2.08	1786.99	38.85	138.83	3.02	12.98
1992-93	2.24	2093.00	45.50	177.85	3.87	13.40
1993-94	2.38	2416.48	52.53	253.07	5.50	13.93
1994-95	2.57	2939.9	63.91	290.68	6.32	14.65
1995-96	2.72	3562.13	77.44	364.70	7.93	15.26
1996-97	2.85	4126.36	89.70	392.49	8.53	16.00
1997-98	3.01	4651.71	101.12	439.46	9.55	16.72
1998-99	3.12	5275.15	114.68	489.79	10.64	17.15
1999-2000	3.21	5728.87	124.54	539.75	11.73	17.75
2000-2001 (projected)	3.37	6503.32	141.38	611.75	13.30	18.56

major problem. Short-term finance presently available to the sector falls much below the 20 per cent of their annual production as recommended by the Nayak Committee. The flow of long-term loans for capital investments from DFIs has, by and large, been adequate. The total term loan requirements of SSI at INR 130,000 million during the 9th plan period have been met far in excess of the target by the DFIs and the estimated requirement of INR 360,000 million during the 10th five year plan by the Planning Commission is also likely to be met in full.

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➤ Constraints

Viewed from the small entrepreneurs' angle, major financial problems are: inadequate availability of working capital, a wide time gap between working capital and term loans, banks' insistence on collateral and third party guarantees, higher promoters' contribution, a risk averse banking system for small projects, delayed payment of bills by large industries, PSUs and government departments. The DFIs and commercial banks generally view small projects fraught with risk due to nondisclosure by the borrowers, lack of authentic information on technology, markets, and investment potentials, a high rate of obsolescence of technology, low quality standards, heavy reliance on traditional channels of debt, high transaction costs, inability to sustain market fluctuations and sagging international competitiveness.

4.5.2 Indonesian SME

✓ *Definition of an SSE*

In a developing country like Indonesia, the majority of the enterprises are smaller in scale. In Indonesia, SSE is defined as an enterprise which is small scale in terms of the amount of capital or labor use. In addition, the SSEs are colored with social aspects. They are mostly traditional enterprises as opposed to modern enterprises.

SSEs have greater flexibility which allows them to survive economic slumps as compared to the large scale enterprises. Moreover, the decision making and innovation processes in large scale enterprises are inhibited by rigid bureaucracy. Therefore, SSE development is important and needed by the nation.

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Small Industry and Trade is defined as a people's economic activities that has

- i. An asset of no more than Rp. 2000,000,000 (two hundred million rupiah) excluding the land and building, equivalent to US\$ 23,500.
- ii. An amount of sales no more than Rp. 1,000,000,000 (one billion rupiah) annually. Equivalent to US\$117,650.

Medium business is a company is a company that has an asset between Rp.200,000,000 and Rp. 10,000,000,000 (ten billion rupiah), equivalent to US\$ 23,500 and US\$ 1,177,000.

SMEs (enterprises under US\$ 5M in Sales) in Indonesia have been so far playing as main contributors in economic activities, for the facts that:

- 99% of the total number of enterprises,
- Absorb 99% of labor forces,
- Contribute 58.2% of GDP,
- 74% of SMEs located in small cities or rural areas,

Indonesia is still suffering the repercussions of the economic and financial crisis in 1997/98. The lack of domestic and international investment and the reduced number of exports clearly hamper opportunities for employment and income for the growing population. Small and medium enterprises (SME) have still not been able to adapt to the changing economic environment.

Central Java, home of 15% of the Indonesian population, is one of the priority regions of the Indonesian-German Co-operation. SME, which play a prominent role in this region in terms of income and employment, have been particularly affected by the crisis. At the same time, with the current trend of decentralization, provincial and district governments now face the challenge of taking the lead in planning and implementing regional economic development.

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The Regional Economic Development Program (RED) aims at improving the competitiveness of local firms and the region as a whole, whilst sustaining business development within a pilot region in Central Java. In Klaten and the surrounding districts Boyolali, Sukoharjo and Surakarta, the program will encourage a comprehensive dialogue in the region at district and provincial level with the private sector, investor partnerships and the local government, and strengthen the supply of services for SME.

The Regional economic development and employment promotion, therefore, are managed in partnership with regional and relevant local public and private partners. The five main key areas are each divided into a number of different measures.

➤ Indonesian SSE: Survey Result Observation

On the other hand, there are also problems faced by the Indonesian SSEs. This can be shown by the result of a survey done by CBS (Central Bureau of Statistic). The findings showed the various difficulties faced by the SSEs as well as their advantages.

The Distribution of Enterprise according to the type of difficulties encountered is as follows:

Shortage of capital	60,776 (35.1%)
Difficulty in marketing	45,386 (25.9%)
Stiff competition	28,149 (16.1%)
Difficulty in acquiring basic material	27,149 (15.4%)
Lack of production technique and expertise	6,347 (3.4%)
Lack of managerial skill	6,340 (3.4%)

➤ Problems faced by SSEs in Indonesia

- Credit programs are a main source of problem faced by SSEs.

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- SSEs face technical constraints due to their traditional production process passed down from generation to generation. They are unable to introduce modern equipment and machinery to improve their production process due to financial constraints. Moreover, they are not familiar with the usage of the equipment.
- Difficulty in acquiring cheaper basic materials increased the cost of production of SSEs.
- SSEs face difficulties in marketing due to their shortage of capital. A more favorable marketing system like sub-contracting or group marketing are promising alternatives.
- The most prominent competition faced by SSEs is the competition between traditional versus substitute products. For instance, plastic or fiber products are often preferred to ceramic products.

➤ The Marketing Destinations of the SSE Products

Domestic market	114,117 (92.7%)
Mostly domestic market	4,726 (3.8%)
Entirely export market	1,470 (1.2%)
Partly export market	2,368 (1.9%)

The SSE products are primarily allocated for the domestic market. It is however, important to observe the export figures above. Some 1,470 enterprises have exported all their products, and some 2,368 enterprises, part of their products. There are some 94.4 % of the 18,564 exporting enterprises are exporting their products through third parties and other sources. Only 482 enterprises which are capable to export their own products. The most prominent enterprises were timber/ wood, metal and textile industries.

To market their products, the SSE needs marketing practices especially market niche. The following data reveals information about marketing channels:

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- End-user 42,713 (28.9 %)
- Middlemen 84,936 (59.5 %)
- Co-operatives 1,842 (1.2 %)
- Exporters 4,496 (3.0 %)
- Others 13,627 (9.2 %)

From its record, producers of paper and mining product sell most of their products directly to consumers. The problem is mutual relationship between producers and traders. In general, producers are in a weak position, particularly if their products are spoiled easily such as food and agro-forest products. The other problems are depressing of price by traders, capital constraints and high labor cost.

The Training Skills Program Received by the Management and Officials/Workers

- Management: 5,612 (4.3%)
- Production Technique: 13,147 (10.1%)
- Marketing Technique: 4,495 (3.5%)
- Others: 2,146 (1.6%)
- None: 104,166 (80.6%)

It is interesting to observe the above results especially to predict the technical assistance assessment. Most of the enterprises have never received any skills from training programs, conducted either by government institution or private/ NGO. It could be that the programs need improvement on determining target group, method, content or other aspects of technical assistance programs.

Some key points from the survey result can be considered for the ASEAN-EU Partenariat program:

- The term host company for the ASEAN should address more to the location in where this program is to be held, but there is also a need to increase or improve SME partnership through trading (export/ import) as well as investment in the region which is the main priority.

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- In business it is understood that partnership should develop using businesslike and professional approach, but the SME partners from advance countries should take into consideration the weaknesses, difficulties, constraints as well as the social role of SMEs from developing countries.
- Most of the technical assistance programs came from the advance countries. It is good if this partenariat program can bring along technology transfer from advance country to developing country so as to maximize the benefits and advantages for both parties.

4.5.3 Small and Medium Industries in Malaysia

➤ Introduction

Malaysia has transformed from a commodity-based producing nation to being a manufacturer of industrial products, geared towards exports. With a good track record of economic growth exceeding 8% per annum, the country is well poised to fulfill its vision of becoming fully industrialized nation by the year 2020.

Following a period of rapid expansion in the last eight years, the Malaysian economy is estimated to expand at a more sustainable pace as the year progresses, where the main impetus to growth continues to come from the manufacturing sector which is envisioned to record a double-digit growth.

In the external trade scene, export of manufactured goods continue to remain the largest contributor to Malaysia's total exports; where product enhancement, competitive pricing and improved marketing strategies have enabled Malaysian manufactured goods to penetrate non-traditional markets like Africa and Oceania. In terms of composition, electrical and electronic products continued to compose the largest share of the export structure, where it grew from 37.7% in 1991 to 52.95% in 1996.

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➤ Role of SMIs in Malaysia

The small and medium industries (SMIs) assume a critical role in the country's industrialization program through the strengthening of both forward and backward industrial linkages. The Second Industrial Master Plan (IMP2) recently announced by the Government, provides the basis for the achievement of a broad based, resilient and internationally competitive industrial sector. It has also set in place policies and programs to further develop and integrate domestic SMIs as the critical and strategic link to develop and strengthen the cluster formation and to increase domestic value-added. The SMIs will assume these roles by complementing the activities of the large scale industries through integration into the mainstream of the industrial development through the provision of critical parts and components as well as expanding their market internationally. As the SMIs grow, their progress will strengthen and widen the industrial base as well as enhancing export-led growth.

➤ Profile of Small and Medium Industries in Malaysia

At present, the small and medium industries (SMIs) account for more than 80% of the total manufacturing establishments in Malaysia; where 88% are Small scale Industries and 12% belongs to the Medium scale Industries.

The SMIs have experienced substantial gains in productivity, even though they only contribute 13.8% to total output and 17.4% to employment. Added value per employee grew at an annual rate of 6.4% for the period of 1991 to 1996. It has seen a steady rate of growth for the period and rose from 29.6% in 1995 to 30.5% in 1996. The majority of SMIs are still concentrated in the traditional sectors of:

- Food and beverages (20%)
- Fabricated metal products (18%)
- Wood and wood products (17%)

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- Basic metal (4%)

However, only 20% of the SMIs actually export their products. The major contributions to Added Value per Employee growth came from the sub sectors of automotive, electrical and electronic products where subcontracting activities were most prevalent with the Government taking a proactive role in these activities. The improvement in Added Value per Employee was due to an increase in Total Output per Employee at an average growth rate of 4.3%. The positive growth is also reflected in Added Value per Total Output with a growth of 2.0% for the 5 year period up to 1996. The high growth in Total Output was consistent with the increase in local and export demand for electrical and electronic products and machinery and equipment creating demands from the larger industries for supply and intermediate products produced by the SMIs as they respond to the market demand. This positive growth was also to the extent due to the proactive role undertaken by the SMIs; coupled with the incentive schemes and supports extended by the Government through various policy measures and generous tax incentives. The policy measures include fiscal, monetary and administrative assistance to encourage investment, R&D, export and Human Resource Development.

The SMIs continue to undergo intensive product specification, design and engineering activities, improvement in marketing and distribution to enhance further their prosperity especially in preparing them for the global market. Efforts had been taken to improve technology accumulation and enhancing the quality of their labor force through education, experience and skills development by optimizing the benefits and incentives made available by the Government.

➤ Strategies and Programs to Enhance SMIs Competitiveness

The important role the SMIs assume in Malaysian industrial development and the problems faced was given serious attention in Malaysia's Second Industrial

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Master Plan (IMP2). IMP2 will set in place policies and programs to further develop and integrate small and medium industries as the critical link for the creation and strengthening of clusters and increasing value added. The trend towards global market orientation and trade liberalization requires the SMIs to increasingly emphasize on compressed product life-cycles, enhancing quality improvements, and towards product and process innovations. Therefore, such emphasis demands more developments in research and development (R&D) and technological advancement to enhance SMI competitiveness. Such is the importance of these aspects that several comprehensive programs had been developed and spearheaded by the private sector supported through technical and financial assistance by the Government.

The development strategies for the SMIs in the Industrial Master Plan emphasizes on linkages between SMIs and the larger industries and to facilitate SMIs to penetrate the export markets. These strategies are implemented through new programs such as the provision of industrial infrastructure and soft loan schemes to facilitate their expansion and modernization. In addition, existing programs such as vendor development, integrated marketing and the industrial technical assistance fund were continued.

In line with the industrial policy to promote exports, a strong, viable and modern export oriented SMIs sub sector will be emphasized to ensure a balanced and efficient industrial structure in the country. The development strategy will be readjusted to adopt a two-pronged approach: to promote production efficiency and to consolidate, strengthen and extend the outreach of existing SMI programs.

➤ Establishment of the Small and Medium Industries Development Corporation (SMIDEC)

The SMI development programs in the country are undertaken by the Small and Medium Industries Development Corporation (SMIDEC); a single agency

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dedicated to improve and coordinate such programs, to spearhead the development of a new generation of SMIs and to implement suitable development programs which can contribute towards a sustainable economic growth.

✓ ***Objectives of SMIDEC***

- Develop SMIs into viable support and ancillary industries capable of exporting high quality and high value-added products.
- Formulate and implement industrial linkage programs (ILP) to link SMIs to LSI and MNCs as well as between SMIs.
- Review existing development programs to formulate plan of action.
- Formulate steps to implement and upgrade technology development among SMIs

✓ ***Functions***

- Provide technical support and advisory service for the enhancement of the growth of SMIs.
- Seek opportunities for industrial linkages within the various industry clusters.
- Promote human resource development in the SMIs.
- Undertake promotional activities for the growth of SMIs including participation in specific technology exhibition, seminar, domestically and abroad.
- Promote mutual co-operation among the SMIs through amalgamation of business, technical co-operation, establishment of mutual fund of co-operative enterprises and the procurement of common equipment.
- Act as a referral and dissemination centre of information related to SMIs.
- Co-ordinate with other agencies on programs pertaining to the development of SMIs.

➤ **Future Direction of SMIs**

The SMIs in Malaysia will transcend from their present state to undertake a more important role in order to support the requirements of Malaysia's industrialization process, and conforming to the guidelines set by the Second Industrial Master

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Plan (IMP2). The importance of the small and medium industries will become more significant as the country expands its industrial base in meeting the challenges of the next millennium. The SMIs are expected to complement the activities of the large scale industries through provision of essential inputs and components that will form the critical linkage between industries, thus building and enhancing the backbone of Malaysia's long term industrial development program.

4.5.4 Small and Medium Enterprises in Singapore

➤ Introduction

Small and medium enterprises have played an important role in Singapore's economic development. They employ about half of the working population and contribute close to a third of the total value-added in Singapore.

A small and medium sized enterprise is defined as a company with at least 30% local shareholdings and less than \$15 million in fixed productive assets (in terms of net book value). For the service company, it must have less than 200 employees.

When Singapore launched its industrialization program in the 1960s, many local entrepreneurs responded accordingly and answered the initial call for import-substitution and supported the activities of multinational companies by supplying critical parts, components and services.

Drawing on their traditional strengths in entrepot trade, SMEs helped Singapore embark on three decades of export-led growth making it an attractive trading hub. In doing so, they have also helped to build Singapore's industrial base. With its supporting industries, it has provided an additional attraction for foreign investments.

➤ Creating the Environment

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SMEs are an integral part of the economy and an important supporting source of components and materials for the larger industries. Realizing the key elements of a better environment for growing business are in enterprise culture, a good infrastructure, strong business and education links, and a highly efficient market, the Singapore government has established comprehensive programs to help SMEs overcome the constraints of size and resources. One of which is Networking. This is being used extensively to tap the expertise and resources of the private and public sectors in order to reach out to the mass of SMEs. The network include universities, technical colleges, training institutes and centers, chambers of commerce and business associations, banks and financial institutions, consultancies, large companies and government agencies. This has resulted in assistance from both the private and public sectors and has improved the SMEs' performance and transformed them into more vibrant organizations with innovative ideas, better management and more responsive corporate structures.

Today, the SME sector has evolved from its trading and light industry base to undertake a broad spectrum of modern economic activities. With its more than 90,000 SMEs constituting nearly 92 per cent of the total number of establishments, the SMEs are a key component of the manufacturing, services and commerce sectors, supporting the MNCs as well as engaging in the development and utilization of proprietary expertise.

Taking advantage of Singapore's strong business and cultural links in the Asian region, the SMEs with their knowledge of the businesses of the West and the East, are also teaming with overseas investors to reach out to the region.

In addition to close business co-operation between Singapore and its ASEAN neighbors, many of these SMEs have also ventured outside the ASEAN region to establish joint venture operations in countries like India, China, and South Africa. A good number have also served as investors, equity partners and consultants in industrial park projects across the region.

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➤ Encouraging Performance

The importance of SMEs is reflected in their significant contributions to the Singapore economy. The manufacturing sector alone has consistently accounted for about 8 per cent of the total value-added, rising from \$4.3 billion in 1990 to \$5.4 billion in 1993. This represents an annual growth rate of 8 per cent.

The productivity of the SME sector, measured by the value-added per worker, has also been climbing steadily. Between 1987 and 1993, it rose from \$27,000 to \$43,000, a 58 per cent improvement.

Singapore-EU Bilateral trade has also been encouraging. Trade with EU countries has grown by more than 65% in the last seven years.

Overseas MNCs are beginning to view Singapore as a regional business hub, with strong logistics and headquarters capabilities and many have tapped on the local enterprises' expertise to support their operation needs for their regional headquarters

➤ Establishing Relationships

More SMEs are also establishing business relationships with companies in Europe, ASEAN and the Asia-Pacific region. They are aware that the key to success in this increasingly globalize environment is greater business collaboration by coming together to form business partnerships for mutual benefit. These may take many forms, such as joint ventures, franchising, licensing and other forms of co-operation in financial, commercial and technical areas. ASEAN-EU Partenariat '97 will provide an excellent opportunity for Singapore SMEs to establish new business collaborations with European SMEs and also other ASEAN SMEs.

4.5.5 China's Small and Medium Enterprises

➤ Introduction

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The Chinese government is improving the "enabling environment" for small and medium-sized enterprises (SMEs). Challenges marring this bright spot of economic reform include insufficient access to capital and local corruption that saps SMEs' dynamism. Nonetheless, flexible SMEs are generally well positioned to take advantage of opportunities created by China's entry to the WTO.

The growing significance of SMEs in China's economy is hard to ignore. Chinese and foreign experts estimate that SMEs are now responsible for about 60% of China's industrial output and employ about 75% of the workforce in China's cities and towns. SMEs are responsible for creating most new urban jobs, and they are the main destination for workers laid-off from state-owned enterprises (SOEs) that re-enter the workforce.

The Chinese government is acutely aware of the impact that SMEs as job-creators can have on forestalling potential social unrest. Chinese officials have said that SMEs would be more important for preserving social stability than the nascent social security system once increased foreign competition as a result of China's WTO entry forces more layoffs from uncompetitive state-owned firms. Local experts have offered an important caveat: many workers let go from SOEs are 40- and 50-somethings who lack the skills needed to succeed in more competitive private ventures.

➤ Improved Ideological Climate

Chinese SMEs have flourished as ideological barriers have fallen. Many SMEs are truly private firms, started by enterprising individuals. In the early days of China's economic reforms, private firms faced an openly hostile political atmosphere and, as a result, were extremely limited in scale. The 14th Party Congress in 1992 saw the announcement of the socialist market economy, which implied that firms in the non-state sector would play an important role in national economic development. The 15th Party Congress in 1997 made this position official, openly acknowledging that the private sector was an important component of the economy. The revision of the constitution two years later

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equating the state and non-state sectors further improved the political environment for private entrepreneurs, as did Jiang Zemin's call last July to expand Party membership to incorporate "new elements of society," including private entrepreneurs.

In addition to private firms, some SMEs were "collectives" (i.e. operated by authorities below the county level) rented by individuals who offered to manage them and use their semi-public ownership status as protection from official harassment. These SMEs expanded considerably throughout the 1990s under the second half of the landmark "grasp the large, release the small" (zhua da fang xiao) policy for state-owned firms. Under this policy 80% of the hundreds of thousands of state-owned SMEs changed their ownership status through corporatization, shareholding, or private management through leasing the enterprise. The State Council Commission to Reform the Economic System managed the process until the 1998 government restructuring, when responsibility was shifted to the State Economic and Trade Commission's (SETC) new SME office.

SMEs still lack access to the resources lavished on larger state-owned firms, according to investment statistics. During the first three-quarters of 2001, private sector investment was US\$ 30.7 billion, up 7.9% year-on-year, while public sector investment was US\$ 191.7 billion, up 18.2% year-on-year. Widespread wariness by both borrowers and lenders of the higher risks accompanying private projects is a key cause of the slower growth in private sector investment. The central government is concerned about this imbalance. The State Development Planning Commission is attempting to address the slow growth in private investment by announcing incentives to "guide" private investment towards public works and high-technology projects.

Chinese officials have said that banks are "too conservative" to lend money to SMEs. Loan officers in state-owned commercial banks are not rewarded for

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making good loans but are penalized when they approve loans that are not repaid. Other officials are blunter: the state-owned commercial banks will continue giving priority to large state-owned enterprises because of their implicit government guarantees. Some SMEs, usually former collectives, do in fact turn to the banking system for at least a small portion of their lending needs. In these cases, SME managers typically use their housing as collateral. As a result of the banking system's continuing preference for lending to large state-owned firms, SMEs usually raise money through indirect financing, primarily from family members or from their local communities. Retained earnings are another key source of financing.

SMEs generally do not receive central government approval to list on China's domestic stock exchanges, which are still dominated by politically connected state-owned firms. One consequence of widespread bad bookkeeping by these large listed firms is that it has delayed the launch of a second board for smaller, more dynamic firms. Prior to the suspension last October of sales of state-owned shares (which was having a negative impact on domestic markets), officials said that the second board proposal was on hold because similar stock exchanges around the world had been performing poorly.

Chinese officialdom recognizes that vibrant SMEs are an essential part of sustained economic development and are trying to improve their "enabling environment." At the national level, the focus is on the forthcoming SME Promotion Law, which will codify the official definition of SMEs and clarify what government financial support will be made available to them. The law should help to protect SMEs, particularly former township and village enterprises (TVEs) that had become share-issuing firms, from corrupt officials. These former collectives, who had close relations with local government officials when they were TVEs, were particularly vulnerable to extortion by those same officials who are familiar with the firms' financial resources.

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➤ Credit Guarantees to the (Eventual) Rescue

Recognizing the limited financial opportunities available to SMEs, the central government created a network of credit guarantee agencies in the late 1990s and tasked the SETC's SME Bureau to oversee them. The bureau maintains a catalog listing what kinds of firms can apply for a guarantee. After checking on a given firm's financial background (using data provided by the State Administration for Industry and Commerce) and reviewing the proposed project, one of the more than 200 guarantee agencies nationwide uses the SETC's money to guarantee that the SME in question will repay its bank loan. The bureau presently manages guarantees worth about US\$ 120 million a year.

Jiangsu Province's Zhenjiang City has been touted as a model for the credit guarantee system. Local officials have said that SME's with successful track records are the main beneficiaries, but firms that could offer convincing explanations for past failures could also participate. Existing firms receive 70% of the city's credit guarantees, while the rest has been dedicated to high-tech startups. Because the latter typically lack track records, the city relies on a panel of experts to assess their business plans and loan guarantee applications.

➤ Some Early Problems

China's nascent credit guarantee system is a step in the right direction, especially until the banking system makes lending decisions on a strictly commercial basis. Nonetheless, by SETC criteria, less than 1% of China's small and medium firms actually qualify to use this system. It is too early to tell if the SETC's vetting process will remain free from the political interference seen in other parts of China's financial system.

A study by the State Council's Development Research Center found that some credit guarantee companies preferred supporting larger firms over smaller ones, viewing the latter as too risky. The study also concluded that banks have been able to shift nearly the entire liability burden onto the credit guarantee companies,

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thereby undermining one of the central government's goals of strengthening the credit risk assessment ability of the country's state-owned banks.

➤ Old Habits Die Hard

Another factor limiting SME development is the mindset of their managers. Some SME proprietors respond to China's uncertain regulatory environment by not fully expanding their businesses. They know that being "too successful" could draw the attention of local government officials who then might impose high levies and fees. In this context, the long tradition of family-based businesses also works to limit the development of SMEs. Many of these firms are unwilling to transform themselves into larger corporate entities because that would require entrusting non-family members with the firm's valuable information and resources.

Not surprisingly, SMEs are not eager to shoulder more of the national tax burden, which is still primarily carried by the state-owned sector. Even in the self-declared SME heartland of Zhenjiang City, small and medium-sized firms pay a disproportionately small share of taxes. The irony for SMEs is that by not paying more taxes to the central government, they are not able to buy the center's "protection" from predatory local officials.

➤ WTO Accession Should Help

Central government officials turn giddy when describing how SMEs can take advantage of China's WTO entry. Senior Ministry of Foreign Trade and Economic Cooperation (MOFTEC) officials have said that SMEs can further integrate themselves into multinational companies' supply chains so China's "small giants" can one day become "big giants" in their own right. That said, while SMEs are better positioned than most of the state-sector to adapt to the new environment WTO membership will not immediately or painlessly improve most SME's plight because they will need time to improve their competitiveness and product quality.

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Officials, frustrated by the state sector's grudging attitude towards reform, cite the principle of "national treatment" in WTO as an additional benefit because it creates new opportunities to launch businesses in industries now dominated by state companies. Moreover, existing SMEs have been disadvantaged vis-à-vis SOEs and would benefit from "national treatment." These officials maintain that China will not achieve the socialist market economy until government at all levels promotes transparency and ends direct government intervention in management. MOFTEC officials late last year said that SMEs were better positioned to adapt to the WTO economy because they lack the social, managerial, and financial baggage of most large state-owned firms.

➤ Comment: They Might be Giants

The most remarkable aspect of China's small and medium enterprises is their rapid growth despite their inability to tap the official financial system. Two factors predict even faster development in the near term. One is their suitability for the post-WTO accession economy. SMEs in China will continue to thrive as more responsive partners of foreign companies than large state firms. They will also have the opportunity to move into market segments once dominated by state firms.

The other factor is that the policy environment for SMEs appears to be steadily improving. The SME Promotion Law will help, especially if it means better access to bank lending, as would improvement in, and expansion of, the credit guarantee system. An important indicator to watch will be whether the 16th Party Congress later this year builds on the progress made at the previous two Congresses in fostering an ideological framework conducive to SMEs.

Jiang Zemin's "Three Represents" concept and calls for expanded Party membership also point to a more benign political environment for SME managers. These political currents could turn into liabilities for SMEs, however, if their

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managers become distracted with Party activities instead of running their businesses.

SME's development will not be without difficulties. Official corruption remains the biggest threat. This phenomenon will persist as long as SMEs lack effective legal and political protection from local officials. To stay off their scopes, many SME managers will likely continue avoiding aggressively expanding their businesses, to the detriment of economic growth and job creation. In that vein, SMEs will not be a panacea for preserving social stability since many older, poorly educated state-sector workers are ill-equipped to succeed in a more competitive labor market.

4.6 World Trade Organization and SMEs

4.6.1 WTO Impact on the Overall Economy of Pakistan

At a time when the world is upbeat about the implementation of the World Trade Organization (WTO) agreement and introduction of revolutionary changes in international trade as its consequence, it is important for Pakistan to gauge its independent standing in this economic shift. Do we, as a nation realize what globalization and WTO are? What are its rules and regulations and how it is going to affect Pakistan's trade and industry? Does it offer any benefits or is it a threat to our economic standing? And above all are we in a position to protect our interests or get relief from competent courts of law in case we think we have been treated in a discriminatory manner in a particular case?

Pakistan, like all other developing countries, is in the process of implementing the provisions of WTO. As a result, its trade and industrial sectors are undergoing radical changes in compliance with GATT/WTO rules and regulations. Where these rules give industries and business enterprises certain rights, they also place some obligations on them.

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Unfortunately there has not been enough development in Pakistan to raise awareness and understanding about WTO. With not much time now remaining for the WTO (till January 2005) to be fully effective, there is an urgent need for all the stakeholders, those involved with international trade and industry in particular, to explore WTO's implications.

Business leaders dealing in international trade believe WTO is the only international body dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations. These documents provide the legal ground-rules for international commerce. They are essentially contracts, binding governments to keep their trade policies within agreed limits. Although WTO became operational on January 1,1995, its trading system is half a century older. Since 1948, the General Agreement on Tariffs and Trade (GATT) have provided the rules for the system. In short, WTO and its agreements now cover trade in services, and in traded inventions, creations and designs popularly known as intellectual property.

Pakistan agreed to join WTO in 1994, one of the benefits of which is the integration of the textile sector into General Agreement on Tariff and Trade (GATT). Looking at 2005, people mostly believe that the major impact of WTO on Pakistan would again be on the textile sector. However, WTO comprises several protocols and agreements focusing on various sectors and has different implications for different sectors and thus the impact might not just be limited to the textile sector. For example, a few subjects or agreements signed by the government mentioned below show which sectors will be the most affected:

1. Improved access to foreign markets (reduction/binding of tariffs, abolition of quotas)
2. Subsidies, countervailing and anti-dumping measures
3. Agreement on Textiles and Clothing
4. Trade-related Aspects of Intellectual Property Rights (TRIPS)
5. Trade-related Investment Measures (TRIMs)

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6. Agreement on Agriculture

Year 2005 is one of the important deadlines by which all negotiations should be finalized and most waivers granted to developing countries like Pakistan should expire. Thus the implication for Pakistan and other countries will be in several sectors and not just confined to the textile sector.

A positive impact of quota free trade on Pakistani textile sector would definitely be an abrupt increase in the demand for Pakistani products for being cheaper in price than they previously were due to no quota charges in the black market. According to textile sector experts, quota is being sold in the black market and constitutes a major part of the exported item's price. After January 2005, experts think that billions of rupees would be liberated from quota trading and will be invested in establishing modern units and improving the efficiency of the established ones.

Pakistan Readymade Garments Manufacturers and Exporters Association (PRGMEA) Chairman Pervez Hanif told that the developed world had also introduced new forms of barriers like the countervailing duty, anti-dumping duties, social, labour, and security issues which will play an important role by the end of 2004. "Pakistani industry is striving hard to reach the required levels of social compliance and is hopeful of securing a grace period to come up to the mark. Otherwise, Pakistan will lose its hard-earned market share to the developed world."

While all sectors of the economy come under the WTO, it severely hits Pakistan's agriculture and those directly or indirectly involved with it. Studies have revealed that the Agreement on Agriculture signed by Pakistan with WTO and the Trade Related Aspects of Intellectual Property Rights are directly relevant to agriculture. However, the fact that Pakistan government organized the first seminar on the Agreement on Agriculture in 1999 -- four years after joining the organization -- shows its lack of awareness and interest in this regard.

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Mubarak Ahmed, President All Pakistan Vegetables and Fruits Exporters told that a gradual phase out of the subsidies being given by the developed countries was agreed to in the Doha Declaration adopted by 142 countries on November 15, 2001, but there was no commitment of any steep cut in these subsidies. "On the other hand the developing countries like Pakistan, whose forte is agriculture, were asked to effect drastic cuts in farm subsidies and finally remove them altogether. There is no sense in abolishing domestic support for our farmers when the developed world like the US and the EU are not themselves ready to compromise on this issue. They have in fact recently increased their agricultural subsidies to help their farmers difficult times."

However, Sharjeel Hashmi, another exporter of agricultural products disagreed with the phenomenon. "There is a code for relaxation under WTO called the Special and Differential (S&D) treatment provisions for developing countries. This is allowed to developing countries in all agreements and under the same Pakistan can give export subsidies to its businessmen. Pakistan falls under Annexure 7 list, i.e. the country with less than \$1000 per capita income, which makes it eligible to get S&D treatment. Most of the reductions in farm subsidies are on account of commitment to the International Financial Institutions, particularly the IMF and the ADB, rather than the WTO, and the commitments made bilaterally to the US and the EU."

The most easily understood effect on the local industry and Pakistan government is that of the WTO's push for an area free of customs duties and tariff protections. Pakistani tax authorities fear a major shortfall in revenue whereas the local industry confronts imminent closures in the face of ever-increasing costs of production.

Against this backdrop, Pakistan has sought US support to help protect its intellectual property rights and around 100 items that it wants to protect from trade liberalization on the pretext of national and geographical identification (GI). The matter gains prime importance due to the fact that India and Pakistan jointly share the

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identification of products like Basmati rice and Alphanso mango and the one who takes the lead in registering the products will enjoy their exclusive selling rights.

4.6.2 Impact of WTO on SMEs of Pakistan

The World Trade Organization (WTO) regime is threatening the very existence of small and medium enterprises (SMEs) in Pakistan.

"WTO? Oh, phasing out of textile quota!" It is how most businessmen in Punjab react to questions about the possible impact of the WTO regime on their businesses and export. It also reflects the level of preparedness to meet the challenges that the post-WTO era is going to pose exporters.

They just don't seem to realize that post-WTO era is not about phasing out of textile quota from Jan 1, 2005 alone; there is a lot more to it than that.

What most people don't realize in Pakistan is that the buyers are going to dictate their own terms on the compliance issues and matters relating to labor, environment, etc. For instance, it is going to be the buyers who'd determine how many toilets a factory needs to have for its work force.

Small and Medium Enterprises (SMEs) are going to suffer directly because of the tariff and non-tariff walls that the importing countries were seeking to build in the post-WTO era (to protect their own commercial interests).

It is the area where the immediate government intervention is desirable in order to support the SMEs against the new walls. The SMEs could never fulfill the compliance requirements of their buyers for being very costly. "If a company is making five products, it will be required to obtain as many echo labels for them, costing it Rs2.5 million annually. The US security concerns require proper security

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arrangements both at the factory premises as well as at the time of loading and unloading of consignments for that country. The costs are too big for the SMEs to bear. The government must intervene now. It is pertinent to mention that areas like Gujranwala, Gujrat, Wazirabad, Faisalabad and Sialkot where small units are clustered lag far behind cities like Lahore in preparing themselves for the post-WTO period.

"It is due to lack of awareness and smaller size of the businesses. Even if somebody wants to do something in this respect, he cannot because of the very high costs involved," said a former president of the Sialkot Chamber of Commerce & Industry. He said Sialkot was a little bit "better" prepared than other SME clusters only because "our buyers have been forcing us to do this and do that in the last few years."

"Had it been left to the government or the exporters alone, we would not have achieved whatever little bit we have on compliance issues," he maintained.

Most of the difficulties would be faced by the textile sector that contributed more than 65 per cent to the country's total exports. Other sectors, like automobiles, would not feel much impact of the walls being erected by the buyers because they were not much into exports. But the farmers would have to improve the quality of their products as well as its packaging if they wanted to compete in the international markets.

The post-WTO era would also bring untold opportunities for Pakistan's exporters, especially in the textile sector. "Sky is going to be the limit for exporters."

Unless investors upgrade the outdated technologies they will not be able to compete with the onslaught of foreign goods that will find their way into local markets in the next few years. According to a recent report prepared by the Small and Medium Enterprise Development Authority (SMEDA), SME sector in Pakistan currently

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employs 80 percent of the total industrial workforce and contributes 40 percent in the country's Gross Domestic Product (GDP).

"It possesses enormous potential to play key role in boosting exports and alleviating poverty in the country. However, lack of congenial business environment for SMEs, coupled with an inhospitable regulatory structure encourages this sector to remain outside the formal economy," states the report. SMEDA's report about the current status of SMEs and the future strategy for enhancing their role in the overall economic growth emphasizes the need to employ new production and marketing techniques in order to prepare them for future global marketing environment.

"With the advent of WTO regime, the international trade will become extremely challenging for Pakistani exports. Particularly, the cottage industry will have to explore new opportunities but not without improving the quality of their products," the report states.

4.6.3 Summing up

There is no running away from World Trade Organization. In fact, from the time when its vocal critics in the country far outnumbered its vocal supporters, we have come to a stage where we find certain NGOs (read activists' groups) thanking the government for kindly seeking their opinion on what is to be done in anticipation of January 2005. Globally, the opposition to the WTO may be more vociferous, more methodical and it may make more sense to a more aware audience. But the thrust everywhere is to seek modifications and clarifications; the deadline for outright rejection of the idea has passed. It's there, until proven a failure, beyond any shadow of doubt.

In Pakistan, it is the same old chain reaction of sorts. It begins with those who say it is too early for us to be entering such tricky territory. Then there are those who say that while we have to join the rest of the world in the march towards the January 2005

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date when the WTO is to fully come into force, we must at the same time press for changes to our benefit. Next comes the non-believers -- people with no trust in the WTO, no trust in those behind WTO, and no trust in the government in Islamabad. Actually, contrary to the image they would want to project, it is these last groups who have chosen an easy way out for themselves. A more realistic approach would be to make your views heard. There is no denying how pro-West these global bodies can turn out to be. But having understood that, staying away from such organizations, or being a part of the proceedings half-heartedly, also serves no purpose. At least some solace can be drawn from the fact that the world has been changing, despite the misdeeds committed on the way. A more informed intervention on our part might have hastened this process of change, and this information can only come if we are aware of the happenings around us, rather than taking the easy option of remaining aloof from the happenings. If world is a stage, there is no audience, only actors.

Studying external environment is rare phenomenon in SMEs. This orientation is incompatible with the centripetal characteristic of the SME which causes resources to be applied almost exclusively to existing products, problems and profitabilities. Even in the pre-globalize world, all progressive companies applied their most important resources in well organized efforts to find out what is happening around the world. Today, this is an absolute must even to survive. This is the precondition to do business in the new World Trading Environment. In all the four scenarios we discussed in the beginning, though the turn of events have been beyond the capacity of small manufacturers to stop, yet they have not been entirely helpless. Most of these events could have been foreseen and planned for. SMEs will have to make determined efforts to know the new system: the threats it exposes them to, the opportunities it springs, the obligations it imposes as well as the rights it enshrines.

One of the greatest conceptual challenges is that on one hand, the individual SMEs would be fiercely competing with each other within the nation and beyond, at the same time they would be forced to collaborate and work together than ever before to safeguard their own mutual interests to survive. The relevance of associations and

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consortiums would increase considerably. Those who would realize their importance would have greater chance to succeed and survive.

Influence of Trading Environment on SMEs : At a glance

Sl	Business function	Trading Environment influenced by
1.	Business idea	- Agreements on Trade Related Aspects of Intellectual Property Rights (TRIPS) under WTO covers Patents, Trade Marks, Copyrights, Industrial Designs, Geographical indications etc
2.	Access to funds	- General Agreement on Trade in Services (GATS) - Degree of openness of Financial sector in the country*
3.	Access to Technology	- TRIPS - Degree of openness of trade regime* - Credibility of legal framework*
4.	Access to competitively priced raw materials	- Degree of openness of trade regime* - Presence of Regulations that discourage collusive and monopolistic behaviour of large producers (Competition Policy or Anti-Trust Laws)*
5.	Infrastructure (Power, Rail, Road, Ports)	- Macroeconomic stability and prudential budgeting* - Level of private participation in infrastructure* - Credibility of legal framework* - General Agreement on Trade in Services (GATS) - Plurilateral Agreement on Govt. Procurement*
6.	Taxation	- Absence or presence of VAT* - Macroeconomic management of economy*
7.	Access to markets / Level of competition	- Multilateral Agreements like: GATT, GATS and TRIPS - Regional Agreements (SAPTA) - Bilateral Agreements (like with EU, USA, Bangladesh, Sri Lanka, Nepal, Mauritius etc.) - Competition Policy or Anti-Trust Laws* - Public Procurement Systems* - Degree of openness of trade regime*
8.	Degree of Quality/ Innovations	- TRIPS - Degree of openness of trade regime* - Consumer redressal & legal framework* - Competition Policy or Anti-Trust Laws*
9.	Competitiveness	- Degree of openness of trade regime* - Competition Policy or Anti-Trust Laws* - Quality of Infrastructure including power* - Competitive Financial sector* - Legal framework*
10.	Ability to exploit growth opportunities	- Insolvency and Bankruptcy laws* - Legal framework* - Attitude of society towards failure*

* Areas where Pakistan's system needs improvement to create enabling environment for growth of economy in general and for SMEs in particular.

Chapter 5: Conclusions

5.1 Employment and job quality

Although detailed and longitudinal data on employment in different classes of enterprises (micro, small, and medium) in different economic sectors including manufacturing, trade and services are not available, some authentic sources reveal that almost 80 percent of non-agricultural employment in Pakistan is generated by the SMEs.

Another important aspect is the determination of factors that lead to creation of these firms. Very few enterprises were started in lieu of appropriate employment opportunities. The main reason for start-ups given by respondents was the sovereignty and independence gained by managing their own business. It would appear that the vast majority of SMEs are established because of strong entrepreneurial drive rather than as a survival strategy in conditions of excess labor supply. Respondents took the decision to start their business based on response to market demand for services and products.

In terms of the quality of employment, SMEs provide basic facilities that constitute the elements of a better working environment (provision of drinking-water, improved work conditions). However, written employment contracts, pensions, insurance, maternity/paternity benefits are generally not provided to employees in the SMEs. A large majority of employees, regardless of enterprise size, are working as full-time permanent employees. They do not enjoy the benefits of full-time employees in large-scale enterprises in the organized sector (social protection, hospitalization coverage, retirement benefits and assistance in child education subsidized by employers and government). The contributing factors to better job quality in large-scale firms are compliance with government regulations, the right to collective bargaining and, to some extent, stringent monitoring and implementation of laws due to the size and location of the enterprise. Until recently, micro enterprises were completely exempt from all the labor regulations, which negatively affected job quality in most SMEs. Even the enterprises with 10 or more employees, which are required by law to be registered with labor departments, often remain unregistered.

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It is generally assumed that the SMEs are unable to achieve sustainable development on their own resources and require public intervention at all stages of their development. It is also assumed that these enterprises respond quickly to public-sector support initiatives, meaning that employment growth in these enterprises is, or should be, highly dependent on government policies. Interestingly, the SME response to market demand is the single most important factor in their decisions on increasing or increasing workers, on improving the quality of employment and on enterprise investment. As the market demand for a product or service increases, the entrepreneur responds by increasing production and will do so if the necessary financial and human resources needed to step up production and delivery are available or accessible. Government policies, labor regulations and special incentive program have only a limited influence on SMEs' decision-making. This influence increases with enterprise size. Most micro enterprises operate in the informal sector and are not required to comply with labor regulations, whereas the small and medium-sized firms that operate as formal sector enterprises and comply with labor regulations are more influenced by government policy when taking decisions to increase or decrease workers. Taxation, labor policy and remuneration rated as the main factors in respondents' decisions to decrease their number of employees.

5.2 The regulatory framework

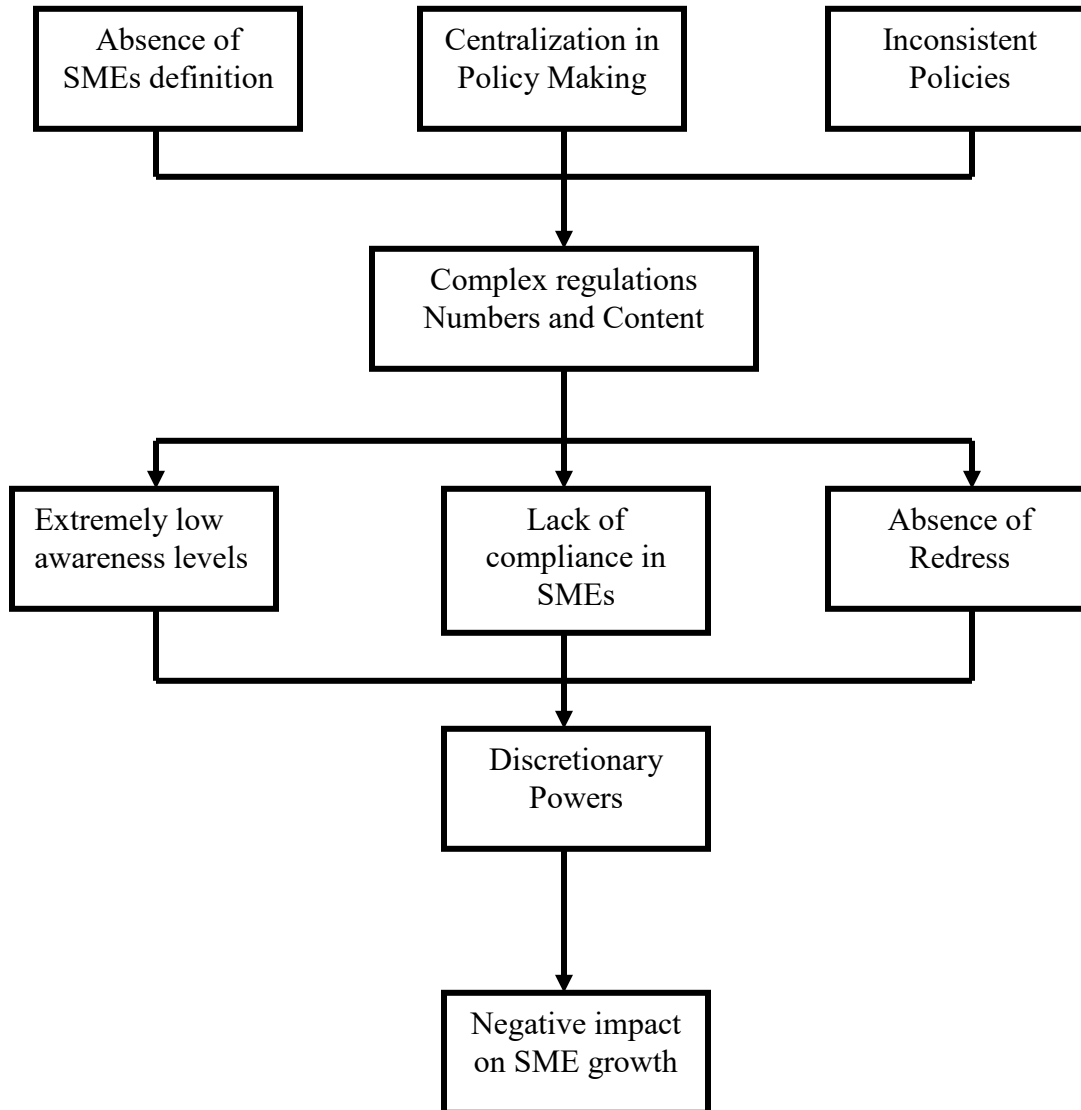
As figure shows, some features of policy-making in Pakistan shape the regulatory environment and its impact on SME growth.

Policies are formulated by the federal government and implemented through various procedures and rules of provincial governments. The labor laws, for example, are formulated federally, with inputs from all the provinces, but it is difficult to tailor them according to the local needs of province-based small and medium enterprises.

Various policies depict certain inconsistencies due to their short-term nature. An ideal example is trade policy, which is announced yearly and yet constantly being amended by a stream of SROs __ making it almost impossible for the SMEs to keep pace with changes in the regulatory environment.

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Figure: Regulatory environment for SMEs in Pakistan



Another factor which aggravates the situation is the absence of a uniform definition for SMEs. It has been repeatedly observed in this report that program are developed by the government without qualifying the term SMEs. Pakistan has not yet reached the stage of designing a policy of promotion and development specifically devised to meet the requirements of MSEs.

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The complexity of the regulatory process and the gaps in policy-making take their toll on the disadvantaged SME sector in the cumbersome procedures and regulations to be dealt with. Considering the low literacy levels of the population, the problem is compounded not only by the sometimes daunting number of steps requirement for compliance but their unnecessarily over-complicated wording in English. Urdu should be the language of choice.

In addition, due to the fragmentation nature of SMEs, the frequent changes in compliance to procedures and their limited awareness of regulatory processes, entrepreneurs are unable to keep pace with the necessary information. Familiarity, even with the basic requirements of various acts and regulations, is lacking, especially in the micro enterprises and those in the lower rung of the small enterprise segment.

This, coupled with lack of capacity for compliance in the SMEs and their lack of redress, leads to undue pressures on entrepreneurs, who resort to settling these matters by paying “speed money” to officials. Discretionary powers can pose a real problem for vulnerable SMEs without the management capacities to comprehend the complexities of the regulatory framework or deal with administrative mechanisms.

Clearly, these are obstacles to the SME enterprises and the government: SMEs remain operating in the informal sector __ because of their lack of awareness of regulatory procedures and also because of their wish to avoid compliance requirements. When the SMEs succeed in increasing their turnover and employment, it is in response to market demand; government regulations play a dormant role in their growth.

5.3 The conducive environment

The main elements of a conducive environment for SMEs are awareness of the regulatory regime, the availability of information, consistency in policies, and transparency in the implementation of regulations and policy measures.

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As figure shows, the SMEDA/Gallup MSE Survey rated these elements for nurturing SME growth on a scale of 1 to 10: the lower the rating, the higher the need for improvement. For respondents, the main priorities were the lack of basic knowledge and accessible information on regulations, developments and incentive schemes; the poor representation of SMEs in industry and trade associations (70 to 77 percent of respondents were not members of any chamber of commerce or industry/trade association); and corruption. Entrepreneurs rated policy applications as consistently fanning out from the central to the provincial level.

According to the survey results, the average score of all conducive elements is slightly above three, leaving a great deal of room for improvement in the policy environment for SMEs in Pakistan.

Figure: Elements of a conducive environment for SMEs in Pakistan

Factors in a conducive environment	1	2	3	4	5	6	7	8	9	10
Policies and laws are not contradictory and easily understood by SMEs										
Administrative decisions are not arbitrary and decision made on objective criteria corruption is absent										
Information on policies is widely and readily available to SMEs										
SMEs are fully aware of policies and laws applicable and incentives available										
Policies and laws applicable are consistently applied from central to national level										
SMEs are well represented through industry and trade associations in policy making										

Source: SMEDA, 2001.

5.4 SME perception of government policies

To survive and remain healthy, SME enterprises must react swiftly to market demand. SMEs show their negative perception of government regulations on the slow, cumbersome documentation procedure; the costs that are incurred over and above the established (actual) costs; and the amount of entrepreneurial time spent in compliance with regulations enforced by the government.

These findings corroborate a study on SMEs in Pakistan conducted by the World Bank (World Bank, 2001). Some salient findings were:

- Small entrepreneurs spend, on average, over PKR 15,000 per and 12 percent of their entrepreneurial time in coping with government regulations, over and above time spent on what they considered “legitimate government demands”. This amounts to around 36 days a year spent on resolving problems associated only with government departments, considering that the majority of micro and small enterprises are self-managed by the owner and that usually no well-defined management structures are in place.
- More than 90 percent of respondents cited government hurdles that affected the smoother functioning of their enterprise. These were rated as: the rising cost of business due to government taxes (56 percent), corruption (39 percent), enhanced utility charges (30 percent) and the “oppressive” role of local officials (26 percent).

In sum, the entrepreneurial time and effort expended on dealing with regulations and government departments were seen impeding on productivity.

Chapter 6: RECOMMENDATIONS

1. Entrepreneurship Programs and Assistance

A small entrepreneur encounters several difficulties in trying to improve his operations through application of new technologies. Primarily, the entrepreneur lacks the experience in determining his technological needs. Secondly, the small entrepreneurs all over the country have limited access to information and developments concerning better technologies that are available. A small businessman has difficulty in evaluating applicable technologies and adapting them to local conditions, thus a major impediment to technology utilization among SMEs. Therefore, it is essential that SMEs should be given assistance through:

- Counseling and advisory services
- Training
- Other means to provide information on setting up new business

Established entrepreneurs require information to expand and diversify their undertakings. They can also benefit from counseling and advisory services.

2. Research and studies

Research and studies play an effective role in providing orientation and information about the industrial sector. The studies also serve as basis for policies and programs for the promotion of small industry and plans for individual units. The common types of studies employed for the industrial promotion activities include:

- Surveys to determine potentials of a given area
- Pre-investment studies and industrial project feasibility studies
- Market surveys
- Industry fact sheets/model schemes

3. Industrial extension services and technical counseling

The obstacles that cause hindrances in the improvement of technical capability of SMEs are mainly brought about by shortage of financing, shortage or inadequate skills of workers, or inadequate knowledge of effective management techniques.

Therefore, advisory services should be provided on/for:

- Selection and utilization of materials, machinery and accessory equipment
- Production processes
- Production planning and control
- Maintenance
- Inventory control
- Cost accounting and control
- Bookkeeping and reports preparation
- Seeking financial and marketing assistance
- Registrations and other legal matters
- Organizational and personnel management problems

Effective tools for advisory services include visits, in-plant studies, on-the-job-classroom training, demonstration, brochures, or through seminars and training courses.

4. Training services for entrepreneurs, managers, foreman and workers

As explained earlier SMEs lack technical experience at all levels thus it is very essential to provide training and technical assistance at all managerial levels.

5. Common service facilities

Sometimes it is more effective to have demonstration and training centers to serve a group of entrepreneurs than to operate on individual basis. Common service facilities may be in the form of testing and quality control labs, common raw material purchasing and stockpiling, common warehouse, etc. These centers are most effective when setting up industrial estates. E.g. machines-lease shops where specialized or expensive machines could be used by small enterprises on payment

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at machine-hours rates is one approach to extending production capabilities. Mobile vans with machinery and equipment are useful for promotional campaigns, training and demonstration and servicing firms in scattered locations.

6. Integrated financial and technical assistance

Technical assistance should be backed up by financial support to translate the advice into actual implementation. Banks are not able to meet the requirement of SMEs for long term capital and equipment financing. Short term loans are also generally inadequate. Therefore, issues relating to credit financing to SMEs need to be resolved. Bank managers also need to be trained to address the needs of SMEs. Supply of machinery through hire-purchase may also be explored.

7. Improvement of design, quality and standards

The improvement of design, quality and standards depends upon the availability of raw material, skill of workers, existing manufacturing facilities, and consumers' preferences. In order to improve quality, awareness about the importance of acquiring and maintaining product quality standards and certifications needs to be created.

8. Management assistance

Assistance needs to be provided to SMEs for the overall management of their companies through training, in the areas of:

- Diagnosis on the status of financial matters, budget and cost control
- Diagnosis in streamlining organizational structure
- Developing personnel policies
- Developing industrial relations and management training programs

9. Marketing assistance

Marketing assistance could be given in the form of joint marketing by groups of manufacturers or industry associations' linkages with wholesalers or distributors.

Methods employed are in the form of:

- Fair and exhibitions
- Marketing consultants for advertising methods
- Market surveys
- Market information dissemination
- Marketing channels
- Restriction on import trade and temporary relief in the form of tariffs and duties
- Joint efforts by SMEs and NPO in the form of advertising, product improvement, quality labeling, etc.
- Marketing and sales promotion in export markets
- Export credit facilities on liberal terms

10. Industrial research and development

In the industrial sector, research and development is carried out in:

- Industrial use local materials
- Industrial use of waste material and by-products
- Investigation of problems of processing
- Development of machineries and equipment
- Work on developing appropriate technologies
- Testing of raw materials and products
- Providing laboratory standards of measurements and calibration services
- Collection and dissemination of industrial, technical and scientific information which is of interest to SMEs

As explained earlier the entrepreneurs of SMEs sector are unable to identify, their own needs and the potential present in the market. Thus R&D plays a key role in the selection of technologies suited to the resources and needs of the country.

R&D institutes can serve the requirements for testing industrial products and

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materials including calibration services. At the same time advisory services could be provided to small entrepreneurs to assess their own needs and to help them diagnose their problems and find solutions. Libraries and information and reference services should be built up in order to provide technical, economical and legal information support.

However, it is generally seen that the entrepreneurs of small industry do not utilize information of the research institutions in an efficient manner mainly due to lack of communication. This is due to:

- Unawareness of the existence of the institute
- Unawareness of the services of these institutes and their potential value to their business
- Lack of technical capability of small entrepreneur in determining and describing their problems

These problems need to be addressed by the NPO through organizing lectures, seminars, and discussion groups of exchange of information.

11. Promotion of subcontracting between large and small industries

Information exchange facilitates the availability of supplies and facilities on the part of subcontracting small enterprise including machines, productive capacities, skills and specializations capability, and certain input material. Large contractor is afforded an expanded productive capacity without the need to handle a broader management problem. Therefore, surveys of firms and their listings should be continuously updated by the NPO. The staff should be able to generate or give technical assistance to SMEs and to counsel them on investments and type of production facilities related to the needs to the large contractor.

12. Training of small enterprise extension staff

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Efficient, qualified and intellectual staff makes a substantial contribution towards economic development program may be designed for upgrading skills of the staff. Advance courses, refresher courses and specialized training can be organized in order to provide knowledge on new methods of extension work, technology updates, and exchanges of experiences. Training programs must be designed for newly recruited staff and specialized courses for extension officers.

13. Institutional development and joint institutional programs

As explained earlier SMEs have poor management structures, accounting procedures, quality standard, access to formal credit and poor marketing access. A group therefore needs to be identified within the industry association to extend the services of NPO to smaller enterprises. These groups will provide assistance in the area of common marketing, export marketing, management, training, financing, credit, common purchasing and other services.

Under joint programs, it is important to:

- Achieve smooth coordination among the different agencies
- Avoid overlapping of functions and activities and undertake careful planning of facilities
- Build technical services and facilities for SMEs

Corporation and coordination may be achieved between National Local Agencies or international Organizations. Through international cooperation exchange of personnel and technical information, training courses, establishment, development and operation of technical services and facilities for small enterprises could be shared.

14. Industrial parks and estates

Functional industrial estates help small entrepreneurs in pursuing their small venture. Industrial parks and estates can also assist small entrepreneurs in sharing resources and skills.

15. Information services

Technical, economic and legal information is disseminated in different forms.

Some of the traditional ways are:

- Enquiry-reply services
- Audio-visual presentations
- Publications
- Tri-media approaches
- Conferences and meetings

New approaches using information technology are:

- On-line information access and inquiry
- Data-bank build up
- Data communications networking among national and international institutions and data banks
- Mobile vans
- Traveling expositions and demonstration
- Businessmen parks, coffee shops and kiosks
- Business information centers

16. Fiscal and investment incentives

In order to attract foreign and local investment various incentives offered by the government are as follows:

- Exemptions and reductions from taxes duties
- Income tax holidays or deductions from taxable corporate income
- Tax credits
- Basic rights and guarantees to investors
- Protection schemes and priorities
- Assistance to investors
- Other special incentives

17. No ambiguity in rules and regulations

The implementation rules and regulations of all pieces of legislation should be free from ambiguity. To achieve this in reviewing legislation the government should define all terms clearly, explain powers explicitly, and prepare lists of documents necessary.

18. Simplifying rules and laws

The government of Pakistan should make a conducive policy environment for SMEs by reducing and simplifying the rules and regulations on labor, taxation laws and incorporation in the country.

19. Streamlining Labor Legislation

Labor legislation primarily should assign levies, set standards of wages and for the work place, and regulate trade union activities. There should be clear guideline and clear definition to the powers given to the labor inspectors so that should be no breeding ground for corruption between labor inspectors and enterprise management.

20. Merging Labor Legislation institutions

The Government should look into the possibilities to merge some or all of the institutions implementing labor legislation, to improve services and reduce administrative costs.

21. Simplifying sales tax registration

Another area of concern is the registration process for the sales tax. Most SMEs perceive this process as too cumbersome. Limiting the physical verifications and expediting the registration process could simplify it. Furthermore, a definite list of documents, which are needed at the time of registration, should be provided to SMEs this would remove any ambiguity of the registration process.

22. Technical grants

The government to arrange technical grants from institutions such as UNDP, US AID, IDB and the World Bank for the promotion of SMEs and the training of the sponsors and employees. As regards ADB, it has recently agreed for providing a US\$800,000 technical grant to Pakistan to prepare a SMEs Sector Development Program. The assistance will develop policy and institutional reforms, including a SME-friendly licensing and regulatory regime, and develop models for business development and financial services customized to the needs of SMEs. Implementation of these measures will be supported under a program, which is expected to start in 2003 and is estimated to cost US\$100 million. Actions may be expedited on this.

23. Income Tax leverages

Income Tax rates may be lowered and discretionary powers curtailed. Simplify procedures for collection of income tax, sales tax and CED; and continue the industrial policies over long periods. Venture capital may be further encouraged, as measures taken in the past have not done much for SMEs.

24. Provision of utilities

SMEs more often deal with the Provincial Government. Law and order situation is of top priority. The government may streamline procedures and enhance facilities in small industrial estates. Once land is purchased, all utilities such as power, gas, water, telephone should be made available. The discretion of officers may be rationalized.

25. Broadening SMEDA's responsibilities

SMEDA should develop databank for enabling the sponsors to operate SMEs more effectively. SMEDA may also prepare standardized contracts, agreements and guidelines for SMEs affairs. SMEDA may develop authentic list of civic, legal and commercial licenses required at different locations and keep it up-dated. SMEDA should coordinate with the investors and SMEs entrepreneurs to identify best investment practices, provide networking opportunities, adapt suitable standards of performance and promote supportive legal / regulatory environments.

26. Loans to right entrepreneurs

Right entrepreneurs for to the right project should be the key policy. Loans should preferably be in small amounts, for shorter duration and given to existing businesses. Business people that have earlier availed micro/small loans and repaid satisfactorily and have expanded the business may be considered for further loans in modest amounts. Databank on industry, projects, sponsors, products, import, exports etc. will be extremely useful.

27. Guidelines for financing

Banks may develop guidelines specific to the financing of SMEs. Loan limits to be set separately for service, wholesale trade and manufacturing projects. Training of bank personnel is necessary in most areas.

28. Reducing gap between SMEs and banking sector

There is a gap between SME and formal banking sector. For bridging the gap the banking sector should

- a. By Minimizing 'RISK' through quality and diversified lending.
- b. By Minimizing 'TRANSACTION COST' through sector specific and Program Lending schemes.
- c. By Making Access to Financing 'Cost Effective' and 'Efficient' by Developing innovative/customized financial services/ products.
- d. By Giving Weightage to credibility appraisal in addition to financial appraisal.

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