

Why Small is Beautiful?

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Why Small is Beautiful?

Sajid Kazmi and Faisal Mehmood Mirza

Abstract

This policy brief discusses the importance of small and medium enterprises in Pakistan in their contribution towards employment provision and export earnings. It also comments upon the problems faced by SMEs and gives recommendations to encourage SME growth.

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Small and Medium Enterprises (SMEs)

Various researchers have defined SMEs based on their legal status, investment ceiling, technological use, employment potential and organizational arrangements.¹ Small and Medium Enterprise Development Authority (SMEDA) defines small enterprises as having 10 to 35 employees with productive assets worth Rs. 2 to 20 million and medium enterprises as employing 36 to 99 workers and productive assets worth Rs. 21 to 40 million.

Based on the above criteria used by various researchers, SMEs are a subset of the larger informal sector. According to The Federal Bureau of Statistics (FBS), the informal sector is defined as, “*units such as household enterprises, engaged in the production of goods and services with the primary objective of generating employment and income (for) the persons concerned, not necessarily with the deliberate intention of evading payment of taxes or other legislative or administrative provisions.*” Furthermore, “*the units typically operate at a low level of organization, on a small scale, and with labor relations mostly based on casual employment.*” Other features include the ownership of assets by “owners” rather than workers, expenditures that are indistinguishable from household expenditures and entities that are not party to contracts or incur liabilities.

A well-established and developed small and medium enterprise (SME) sector has been recognized as one of the characteristics of a prosperous and growing economy. It is considered an engine of sustainable growth by both developed and less developed countries. The small and medium size industries have long been regarded crucial for the achievement of broader development objectives, including poverty eradication and economic development.

In 1950s, leaders of the new nations faced two divergent options for development: a) to emphasize modern technology and big industry, seeking rapid modernization and economies of scale, b) to stress small-scale and labor intensive technology in order to create jobs and enable workers and entrepreneurs to learn from experience in managing large organizations and sophisticated technology. Many countries took the first path, with one-sided results. High growth rates were achieved, while income distribution and equality were ignored. Schumacher (1970) strongly criticized this strategy and argued for alternate, small-scale technologies as the engine of growth. Lipton (1990) exposed urban biases in industrial policy. There is a permanent place for efficient and progressive small and medium scale industries in modern industrial economies as evident in the existence of a large number of small and medium units along side giant enterprises in advanced countries such as Japan, USA and Germany. In OECD countries, SMEs account for over 95 percent of the firms and 70 percent of total employment. The experience of Japan, Hong Kong, South Korea, Singapore and India suggests that a strong and vibrant small industrial sector is necessary for

¹ For details on definitions, see Amin (1987), Aftab (1990), Hart (1970), Haan (1989), Kibria (1990), Mahmood (1999), Nadvi (1990) and Sethuraman (1981).

successful export oriented growth. Much of the growth in output and employment in the 1980s and early 1990s in leading Asian economies came from approximately 25 percent of the firms, which were typically small and medium sized. The SMEs in these economies accounted for around 50 percent of the workforce and generated 50 percent and 35 percent income and exports respectively. In Pakistan, the SME sector accounts for about 40 percent of value added in the manufacturing sector and around 5 percent of GDP. Pakistani SMEs contribute 30 percent in value added exports, but that too in some niche markets like sports goods and surgical instrument manufacturing. SMEs are basically labor intensive and absorb more than 80 percent of the industrial labor force.

This is further supported by the statistics given in Table 1, which suggests that informal sector employs more labor compared to the formal sector. Moreover, it employs about three-fourth of the female labor force in rural areas and just about three-fifths in the urban areas.

Table 1: Proportion of non-agricultural workers (10 years and above) in the formal and informal sector by gender and region (1999-00) (Percentages)

Sector	Rural		Urban	
	Female	Male	Female	Male
Formal	26.9	32.4	39.3	35.9
Informal	73.1	67.6	60.7	64.1
Total	100	100	100	100

Source: Drawn from Government of Pakistan, *Labor Force Survey 1999-00*, 2001, p.21.

If we look at the unemployment statistics, the aggregate unemployment rate between 1987-88 increased by 4.7 percent i.e. from 3.1 percent to 7.8 percent.² This aggregate trend is also reflected in the statistics by major industry divisions reported in Table 2 below.

Table 2: Unemployment rates by major industry division over time

Major Industry Divisions	1987-88	1992-93	1996-97	1999-00
Agriculture, forestry, hunting and fishing	1.0	1.7	3.1	3.6
Manufacturing and mining	4.5	9.0	11.1	12.7
Electricity, gas and water	7.8	3.8	9.1	8.7
Construction	9.9	7.2	7.8	17.0
Wholesale & retail trade	3.1	2.8	4.1	7.2
Transport, storage and communication	7.8	7.9	8.4	11.8
Community, social & personal services	4.5	9.9	10.4	11.7
Others (financing, insurance, real estate and business services and activities not adequately defined)	6.9	10.3	5.4	13.7
Total	3.1	4.7	6.1	7.8

Source: Calculated from Government of Pakistan, *Labor Force Surveys*, 1987-88 (1989, p. 151, 232), 1990-91 (1992, p. xix), 1992 - 93 (1994, p. 28, pp. 215, 420), 1996-97 (1997, p. 26, pp. 116,189) and 1999-00 (2001, p. 18, pp. 142, 215).

Unemployment is on the rise in all the seven major industry divisions cited in Table 2 since 1987-88. Furthermore, this fact is supported by the statistics given in the table 3 indicating that the rate of unemployment in all the major occupation groups has also increased.

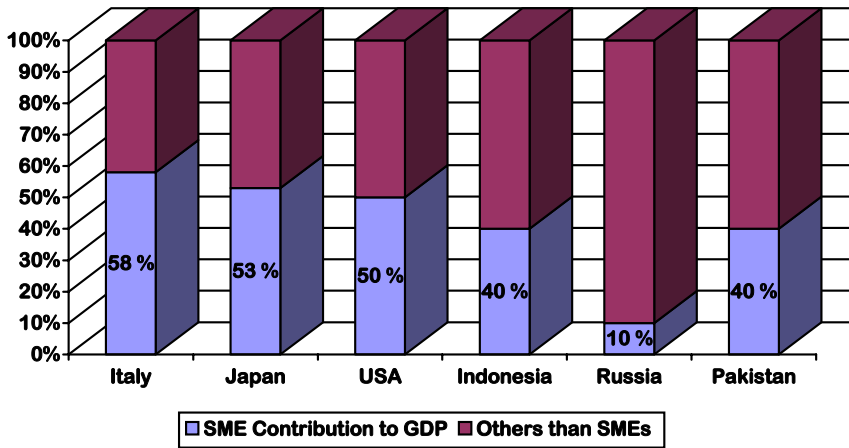
2 Unemployment is defined in the *Labor Force Survey* as follows: "The unemployed comprise all persons ten years and above who during the reference period were "without work" i.e. were not in paid employment or self-employment, "currently available for work" i.e. were available for paid employment or self-employment in the reference period and "seeking work" i.e. had taken specific steps in a specified recent period to seek paid employment or self-employment."

Table 3: Unemployment rate by major occupation groups, 1996-97

Major Occupation Groups	Unemployment Rate (1996-97)	Unemployment Rate (1999-00)
Legislators, senior officials and managers	3.2	5.6
Professionals	12.1	9.3
Technicians and associate professionals	7.1	14.5
Clerks	9.1	12.9
Service workers, and shop market sales workers	10.1	21.1
Skilled agriculture and fishery workers	1.6	2.7
Crafts and related trades workers	8.8	13.4
Plant and machine operators and assemblers	13.6	13.8
Elementary (unskilled) occupations	8.2	7.8

Source: Calculated from Government of Pakistan, *Labor Force Survey, 1996-97* (1997, pp. 111, 215) and 1999-00 (2001, pp. 137, 245).

The chart given below makes a comparison of contribution of SMEs in the GDP of various countries. SMEs contribute 40 percent to Pakistan’s GDP, whereas this contribution is more than 50 percent in the case of Italy, Japan and the USA.



Source: USA-SBA, Office of Advocacy Indonesia Central Bank/SMEs in Pakistan by SMEC-LUMS / Assessment of the Microenterprise Sub-sector in Pakistan, ISSAS, The Hague, The Netherlands.

SMEs sometimes enjoy competitive edge over big enterprises because they need relatively small markets. Products can be tailored to meet the requirements of local markets. SMEs can be very successful in the long-term growth of the economies as they lead to industrialization in rural areas and decrease pressure on the urban areas. They activate untapped resources and skills and have the potential of producing large exportable surplus leading to a decreasing import-export gap. SMEs use indigenous raw materials and help in self-sufficiency of local raw material producing industries and also help in growth of entrepreneurial skills. SMEs are characterized by easy entry and exit in the market compared to large sized firms. The employment creation aspect of this is further emphasized by the fact that cost of job creation in SMEs is much less than in the large-scale manufacturing sector. Kemal and Mehmood (1993) estimated that this

sector could create fourteen times the number of jobs that the rest of the economy can with the same level of investment.

Small and medium enterprises have some strengths that include their adaptability to changing market conditions and are more attuned to market competition, which requires constant innovation. As SMEs have smaller capital-output ratio, it is easy to start a small business as compared to a large business.

The last decade of the last century has shown rapid economic changes. The world has changed to a global village due to globalization and liberalization. The WTO has acted as a catalyst to globalization and after the agreements of TRIMS and TRIPS, the setup of the world economic order has changed completely. Liberalized trade via WTO agreements has compelled governments in the developing countries to decrease protection to the domestic industries. The provisions of the WTO agreements include phasing out of quantitative restrictions, tariff reduction and the elimination of subsidies.

Although, the SME sector has a lot of potential in terms of value addition and employment generation, yet government policies are always biased against it.³ SMEs value added share in manufacturing sector has increased from 27 percent in 1980-81 to 35 percent in 1997-98. Furthermore, its capital requirements to provide employment are very low as compared to large-scale industry. The lack of government commitment to SMEs is reflected in the fact that the last four years, entire investment in the small-scale manufacturing has come from the private sector. Its growth is hampered by a lack of credit, and unequal allocation of credit is an entry barrier. The financial sector is not very supportive of SMEs. The newly established micro-credit bank and establishment of Small and Medium Enterprises Development Authority (SMEDA), to cater to credit needs of the sector, is a positive step in this regard and will hopefully address the issue of credit constraint. The provision of access to capital will play an important role in fostering competition, support existing players and encouraging new entrants. But, here again a note of caution is required since the earlier experience with the public sector banks shows an inappropriate and politically influenced policy of lending. This has given way to the piling up of a non-performing loans portfolio of public sector banks. Furthermore, outdated government regulatory policies, like the state zoning policy also affects the growth of SMEs.

Problems faced by SMEs

The problems SMEs face today are heterogeneous and they arise due to:

- Lack of financial resources
- Inadequate legislation
- Lack of skilled human resources
- Almost negligible investment in research and development
- Poor work ethics
- Low level of industrial linkages
- Lack of export diversification
- No foreign investment or collaboration in SMEs⁴
- Poor infrastructure
- Limitation due to legal framework
- Migration of trained workers to the large enterprises for better pay

3 It provides 80 percent industrial employment and generates one fourth of sector's export earnings.

4 Although, there is evidence of joint venture investment in surgical instruments manufacturing, it is exceptional case.

The Ways Forward

These problems indicate a tough time ahead for our SMEs. This challenge can be met by taking the following measures:

- Simplification of small and medium enterprise registration
- Simplification of accounting system for these enterprises
- Establishment of state guarantee for credit schemes
- SMEs perform best in the countries and cultures, which encourage and support entrepreneurship. Education and training systems have a role to play in developing entrepreneurial values, attitudes and behaviors. Training programmes for SME employees in universities and polytechnical institutes should be needs based to ensure client commitment, particularly by charging services provided, thereby creating a transactional exchange base relationship, with which SME owners-managers are familiar and through which they are willing to pay for the services that they value
- Exchange of experts and consultants for the adaptation and implementation of support and development programmes and services

Conclusion

From the above discussion the role of SMEs and sustainable development is quite evident. An institutional initiative is needed to encourage the growth of SMEs. There is no single most effective system for the development of SMEs. It is a continuous process and requires commitment at the national level with partnership between public and private sectors. The development of this sector requires an integrated approach. The Government should undertake necessary policies and strategies. This may include giving SMEs adequate financial resources, tax holidays, building infrastructure specifically in those areas where SMEs are working. To achieve this goal, it would be necessary to assure supply of capital, skills and technology enhancement and providing market information for SMEs. Efforts should be made to increase the quality of products by a close oversight of the standards setting body.

Flexible and innovative SMEs based on complementary specialization in networking within the region, coupled with trade liberalization on the regional basis can attract foreign investment especially from countries which are now looking for such opportunities due to rising labor cost in producing relatively labor intensive goods in their countries due to their currency volatility. Although, large firms take advantage of foreign investment (through joint venture, technology transfer, sub contracting and other forms of tie up), the foreign investment should also be made to work in favor of SMEs development. It is also recognized that some foreign investments are more directly beneficial to the growth of SMEs than others and should therefore be given priority. For instance, foreign investments may be encouraged to flow into industries where SMEs generally tend to be important in terms of share of industry employment and output. Other such industries are those where such existing SMEs need technological upgrading or those that have strong export potential. At the institutional level, support institutions should be created in public and private sectors. SMEs should employ new technologies, innovation in their products, give professional skill training to their employees, produce such products that meet the demand of the market and are properly marketed.

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