

Entrepreneurship in Pakistan: Government Policy on SMEs, Environment for Entrepreneurship, Internationalisation of Entrepreneurs and SMEs

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I Introduction to Pakistan

Entrepreneurial activity remains limited in Pakistan. According to the 2007 World Bank Group Entrepreneurship Survey that measures entrepreneurial activity in 84 developing and industrial countries over the period 2003-2005¹, the average annual entry rate in Pakistan, calculated as new registrations of companies as a percentage of total lagged (previous year) registered businesses, was 7 percent. As figure 1 shows, this is lower than most regional averages around the world. For example, the entry rate in industrialised countries was 10.2 percent over the same period.

As entrepreneurship is often considered to be important for economic growth (Aghion et al, 1997; Schumpeter, 1934), Pakistan's low entrepreneurial activity is a problem that deserves attention. This chapter includes four subsequent sections. Section II will examine governmental policy on small and medium enterprises (subsequently abbreviated as SMEs) and entrepreneurship in Pakistan to demonstrate that the emphasis in Pakistan has been placed historically on large-scale manufacturing as opposed to SMEs. This has created a challenging economic and sociocultural environment for entrepreneurship and the state of small business in Pakistan on several dimensions, as explained in section III. In particular, contract enforcement is very weak in Pakistan. This chapter will analyze, in some detail, a judicial reform implemented in Pakistan in 2002 to determine whether this reform increased entrepreneurship, and with which cost-benefit ratio. The internationalization of entrepreneurs and SMEs from Pakistan will be discussed in section IV, subsequently followed by a conclusion in section V.

II Government policy on SMEs and entrepreneurship in Pakistan

It is important to examine Pakistan's history in order to understand these low entrepreneurial rates. As Ul Haque (2007) states, following the partition of India in 1947, Pakistan put in place a heavily planned economy. A large set of legislation was created

for a fully government-directed economy. For example, incentives to attract investment, such as licensed monopolies in protected markets and subsidised credit and inputs for certain activities, were designed to develop chosen priority sectors. While directing funds and energy towards these sectors, such policies might have inadvertently encouraged rent-seeking. Indeed, when wealth transfers can be attained through government licenses, policies and directives, entrepreneurial efforts will be directed towards gaining such transfers, and not towards undertaking innovation and bearing risk, which is Schumpeter's definition of entrepreneurship.

In addition to being misdirected, policies in the 50s and 60s did not focus on the SMEs. Ul Haque (2007) shows that between 1958 and 1970, 65 percent of total loans disbursed by PICIC, a public sector financial institution, went to 37 monopoly houses, with the largest 13 of these accounting for about 70 percent of the loans. The nationalisation of the large scale manufacturing sector, insurance companies, and banks under the Bhutto years in the 70s did not reduce elite capture. The Zia years in the 80s saw a shift in the encouragement of the private sector but priority was still bestowed upon large-scale manufacturing. Institutions established to facilitate business activity, such as the Board of Investment (BOI), the Export Promotion Bureau (EPB) or the Central Board of Revenue (CBR), concentrated their efforts on large scale industry². This approach changed in the 90s following the realization that the growth of a globally competitive SME sector through a conducive and facilitating environment could serve as an engine for growth and sustainability to the national economy³. The development of SMEs is now an integral part of important documents such as the Poverty Reduction Strategy Paper (PRSP), the Micro Finance Sector Development Program, the SME Sector Development Program, the Education Sector Reforms 2001-05, the Reform of the Financial Sector and the Reforms in Tax Administration. Additionally, in 1998, in order to facilitate the challenging task of developing SMEs in Pakistan, the Ministry of Industries, Production & Special initiative established the Small And Medium Enterprise Development Authority (SMEDA).

However, in "Developing SME Policy in Pakistan" (2007), the SMEDA recognises

that:

“while SMEs are being mentioned in some of our [Pakistan’s] socio-economic strategies and policy documents, measures are not sufficiently specified and prioritised for us to be able to speak of any coherent SME policy or approach”.

Moreover, and by their own admission, SMEDA has not been provided with a mechanism to initiate, coordinate, monitor, and evaluate initiatives of SME development outside of its own scope of activities (p.3, SMEDA, 2007). Although governmental efforts have refocused towards SMEs, minimal actions have been taken to improve the challenging economic and sociocultural environment for entrepreneurship in Pakistan, which will be described in section III.

III The economic and sociocultural environment for entrepreneurship and the state of small business in Pakistan

Small business plays an important role in Pakistan. Large-scale activities dominate manufacturing output (70 percent of value-added) while SMEs provide the bulk of employment. Enterprises employing less than 100 individuals constitute about 90 percent⁴ of all private enterprises in the industrial sector, and SMEs employ some 78 percent of the non-agriculture labour force⁵. SMEs contribute over 30 percent to GDP, 25 percent of manufacturing export earnings, and 35 percent in manufacturing value added⁶. Although they produce a quarter of manufacturing exports, most SMEs produce low value-added products⁷ that rely on traditional technologies⁸.

Although integral to the national economy, the SME sector seems plagued by extremely low entry rates, as demonstrated in the introduction. These seem to be explained by the extremely challenging economic and sociocultural environment for entrepreneur-

ship in Pakistan, which is well described by the “Doing Business” project⁹ described below.

III.1 The investment climate in Pakistan

The “Doing Business” project tracks a set of regulatory indicators related to the investment climate faced by small and medium sized companies. According to this methodology and the “Doing Business in South Asia 2007” report, it is relatively easy to start a business, register property, deal with licenses and close a business in Pakistan. In contrast, the investment climate is much worse when it comes to employing workers, getting credit, paying taxes, and particularly enforcing contracts.

Pakistan’s labor code imposes rigid hiring conditions and onerous firing procedures (an employer must pay the equivalent of 90 weeks of salary in severance, penalties and notice to dismiss a worker, much higher than in the rest of South Asia). These two elements contribute to Pakistan’s extremely low ranking on the “employing workers” index (126th in the world).

Getting credit in Pakistan is hampered by weaknesses in collateral and bankruptcy laws. According to the “Doing Business” report, Pakistan ranks 93rd in the world on a legal rights index measuring the ability of laws to expand access to credit. However, Pakistan is one of few countries around the world with both public and private credit registries, which translates into greater scope, access and quality of credit information available.

Pakistan ranks 140th on the ease of paying taxes indicator. Pakistan’s tax rate of 43.4 percent of commercial profit is moderate, but the administration of taxes continues to be a principal obstacle to doing business in Pakistan. The current tax code is cumbersome, requiring a standard business to make 47 tax payments per year to various levels of government. Complying with all statutory tax requirements takes an estimated 560 hours per year.

Contract enforcement is undoubtedly the weakest facet of the business environment in Pakistan, ranking 163rd globally. It takes 880 days to enforce a commercial contract,

a process that involves 55 procedures and costs 23 percent of the claim's value. This poor performance is reflected in businessmen perceptions of the judiciary as measured by the World Business Environment Survey (WBES, 2000)¹⁰, which was administered to 103 enterprises in Pakistan in late 1999 and early 2000. Figure II reveals that Pakistani entrepreneurs rate the judiciary systematically lower than their income category average on issues such as the overall functioning of judiciary, speed, and confidence that the legal system will uphold contract and property rights.

This low judicial performance could be explained by cumbersome legislation, inefficiency of personnel, or lack of human or physical resources. In the remainder of this section, I will concentrate on the judiciary, identified as the key weakness of Pakistan's investment climate, and, in particular, on an innovative judicial reform put in place in Pakistan with the explicit objective of expediting its processes.

III.2 The 2002 Judicial Reform

A slow judiciary may affect entrepreneurship by undermining entrepreneurs' confidence in their property rights and by reducing their access to credit markets, as creditors have little assurance that they will be able to recover loans in cases of default (Jappelli et al, 2005). Credit markets further affect occupational choice (Banerjee et al, 1993). This logic generates a testable implication: an efficient judiciary may increase entrepreneurship.

The dire state of Pakistani courts prompted the government to implement the Access to Justice Programme (AJP), which sought to raise the quality of institutions administering justice. The Asian Development Bank provided a \$350 million assistance package to the AJP. The programme was launched in December 2001 and was implemented by the Ministry of Law, Justice and Human Rights.

The reform's most important component was a Delay Reduction Project in the District Courts. Its objective was to introduce appropriate case processing standards, manual record management, and case-flow management systems (Armytage, 2003). The reform was widely criticised in Pakistan, due to its costs (the reform was financed through

a \$350M loan from ADB¹¹) and to its nature (no changes in incentives for judges should result in no improvement of the judiciary). As the expected impact of the 2002 judicial reform that consisted in a delay reduction project is ambiguous, it is therefore important to empirically evaluate its impact on judiciary's speed and furthermore on the environment for entrepreneurship in Pakistan.

III.3 The evaluation of the 2002 judicial reform

Chemin (2007) evaluates the 2002 judicial reform using a unique feature of this reform: caseload management techniques were taught to civil and criminal judges in only 6 pilot districts out of 117¹². Thus, it is possible to compare judicial outcomes and entrepreneurship of both types of districts (pilot and non-pilot), before and after the reform¹³. Figure III shows the mean number of cases disposed per judge¹⁴ in pilot districts as compared to the mean number of cases disposed per judge in non-pilot districts between 2002 and 2003. This figure illustrates an increase in the number of cases disposed by judges (i.e., judicial speed) resulting from the reform. This graphical result is confirmed in a difference-in-differences, multivariate regression framework, with judges fixed effects (that capture time-invariant unobserved judges heterogeneity), time fixed effects and robust standard errors clustered at the district level (Chemin, 2007). Furthermore, these results were robust to controlling for potential concurrent reforms that might have occurred simultaneously (2002) in the pilot districts¹⁵ (e.g. police strength and a general improvement in economic performance). Further figure III shows the similar speed trajectories for the time period directly preceding the reform (2001-2002) for both types of district, indicating that pilot and non-pilot districts are indeed valid comparable areas. The author concludes that judges disposed of 25 percent more cases following the reform in pilot districts. Contrary to the initial doubts about the reform, this shows a positive impact of the reform on judicial speed.

The author further uses three rounds of Pakistan's Labour Force Surveys (collected in 2000, 2002 and 2004), which contains detailed data on entrepreneurship activity, to measure the causal impact of the reform on entrepreneurship. It is found that the judicial

reform significantly improved investors' confidence in their property rights and in their ability to obtain credit. Both mechanisms spurred entrepreneurship. The proportion of the unemployed applying for permits or seeking land, buildings, or machinery to establish enterprises tripled as a result of the reform. This translated into a thirty percent increase in the transition from being unemployed to being an employer or own account worker. There was a similar increase in the number of transitions from being an employee to an employer or own account worker.

If the reform had been scaled up to the level of Pakistan (as planned under the \$350 Million budget equivalent to 0.1 percent of Pakistan's 2002 GDP), these estimates suggest that the entry rate in Pakistan would increase by half, from 2.3 percent¹⁶ to 3.6 percent. This increase in entrepreneurship could translate into an increase of Pakistan's GDP by 0.5 percent according to the 2007 World Bank Group Entrepreneurship Database¹⁷. This suggests an important role for the judiciary in shaping economic activity and, considering the cost-benefit of this reform, for judicial reforms in fostering entrepreneurship.

This section showed that the Pakistani investment climate suffers from several weaknesses, including the regulatory framework to employ workers and pay taxes, and the ability to access credit. However, the main weakness seems to concern the contracting institutions. This chapter provides a description of a judicial reform that was successful (although not scaled up) in improving the environment that SMEs face. Similar judicial reforms might be a cost-beneficial approach to encourage entrepreneurship in Pakistan.

IV Internationalization of entrepreneurs and SMEs from Pakistan

SMEs in Pakistan have had difficulties integrating into the global economy, as evidenced by the dramatic fall in exports from Pakistan in the late 90s (Figure IV). The "Pakistan Country Assistance Strategy 03-05" published by the World Bank finds that, while Pakistan's export performance was equivalent to low and middle income countries and

South Asia, growing at 7 percent or more a year in the 80s, export earnings fell by 2 percent a year between 1992 and 1999. This is in contrast with the continued export growth of low and middle income countries or South Asia in the 90s. This is mainly due to the “bias in resource allocation away from export-oriented and labor-intensive small and medium-size enterprises and toward domestic market-oriented and capital-intensive industries”¹⁸. Previously, section II showed the tendency of Pakistan’s government to design industrial policies that heavily favor large-scale manufacturing over SMEs. An element of this policy was an internally-focused trade regime that protected import substituting and capital intensive industries (fertilizer, cement, synthetic fibers, motor vehicles) through high import tariffs and targeted exemptions, and that simultaneously discriminated heavily against exports by raising the cost of input and raw materials. Moreover, the high degree of political instability in the 90s, which resulted in a series of short lived governments, each with its own priorities and vested interests, exacerbated the opacity of an incentive regime combining high tariff protection with special concessions (exclusive licenses, franchises, tax concessions, preferential access to subsidised credit). Policy shifts in 1997 spurred a move toward trade liberalization: maximum tariff was lowered from 65 percent to 45 percent and the number of concessions were reduced. This initial reform was followed by impressive changes in the last decade according to the “Doing Business in South Asia 2007” report: average nominal protection was reduced from 67 percent to 10 percent,. Moreover, the red tape related to import or export clearance significantly diminished: whereas 34 verifications and 62 steps, comprising 8 days per step and potential interventions from various public officials, were necessary in the past, only 8 (and 12) documents are needed to export (and import) in 2007. As a result, Pakistan now ranks above the South Asian average, on a composite index of tariffs, procedures, time, cost of trading across borders. However, Pakistan still ranks only 98th in the world¹⁹. As a result, Pakistan’s trade levels remain low²⁰ and internationalisation of entrepreneurs and SMEs hampered.

V Conclusion

This chapter demonstrated how, for historical reasons, the emphasis in Pakistan has been placed on large-scale manufacturing, through an import-substitution strategy that protected large scale entrepreneurs from market forces of competition and provided them ample rent-seeking opportunities. This is to the detriment of SMEs that remain largely neglected despite a recent shift in interest towards private sector entrepreneurship. This has created a challenging economic and sociocultural environment for entrepreneurship and the state of small business in Pakistan on dimensions such as employing workers, getting credit and paying taxes, and in particular contract enforcement. Pakistan's judiciary is seriously congested, which could reduce confidence in property rights decreasing investment incentives for entrepreneurs while reducing access to credit, affecting occupational choice into entrepreneurship. A survey of the judicial reform implemented in 2002 in Pakistan shows that it is possible to increase the speed of the judiciary with minimal investment through the training of caseflow management techniques. Subsequently, the impact of an improved judiciary speed significantly increased entrepreneurial decisions to start businesses. It is suggested that this judicial reform, that cost 0.1 percent of Pakistan's 2002 GDP, could translate into an increase of Pakistan's GDP by 0.5 percent through higher entry rates. This suggests an important role for the judiciary in shaping economic activity and, considering the cost-benefit of this reform, in fostering entrepreneurship.

Despite its potential benefits for the economy, the judicial reform was not scaled up in Pakistan. Moreover, several roadblocks remain in the internationalisation of entrepreneurs and SMEs from Pakistan. Until further reforms are implemented, or current reforms augmented, SMEs in Pakistan will still face an adverse economic environment.

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Notes

¹The database includes cross-country, time-series data on the number of total and newly registered businesses, collected directly from Registrar of Companies around the world. This joint effort by the IFC SME Department and the World Bank Developing Research Group is the most comprehensive dataset on cross-country firm entry data available today.

<http://www.ifc.org/ifcext/sme.nsf/Content/Entrepreneurship+Database>

²Developing SME Policy in Pakistan, SME Issues Paper - for Deliberation by SME Task Force - Policy Planning & Strategy Department, Small and Medium Enterprise Development Authority (2007).

http://www.smepolicy.net.pk/SME_Issues_Paper.pdf

³This is the vision of SMEDA (The Small and Medium Enterprise Development Authority):

http://www.smeda.org/SMEDA-introduction_1.html

⁴Pakistan Country Assistance Strategy, World Bank Report, Annex II, Page 3

⁵Census of Establishments-1998

⁶Economic Survey of Pakistan 2002-03.

⁷The most important areas of activity for the SME sector are grain milling (16 percent), cotton weaving (13 percent), wood and furniture (10 percent), metal products (7 percent), and other textiles (6 percent). Cotton weaving and other textiles are their chief exports.

⁸Pakistan Country Assistance Strategy, World Bank Report, Annex II, Page 3

⁹<http://www.doingbusiness.org/>

¹⁰<http://info.worldbank.org/governance/wbes/>

¹¹“The system in short, Can the expensive Access to Justice Programme make the dispensation of justice more effective?” By Adnan Mahmood, Special report, The News International.

¹²In practice, only ten subordinate court judges (seven civil and three criminal) in these six districts in three large urban centres (Karachi, Lahore and Peshawar) were part of this pilot project. However, Prof. Carl Baar, who was in charge of the project evaluation, notes that “the involvement of the four District Judges in the Karachi City Court Complex allowed the pilot project to move beyond its original focus on individual Judges to consider the possibility of backlog reduction in entire districts” in Baar (2004), p. 269. An analysis at the district level will thus measure a conservative estimate of the reform.

¹³It would be wrong to compare judicial performance in pilot and non-pilot areas as judges in pilot areas may be systematically different from those in non-affected areas. It would also be misleading to compare judicial performance before and after 2002 in pilot districts since judges might have solved more cases even without the reform. On the other hand, it is appropriate to compare the judicial performance of judges in pilot districts and non-pilot districts, before and after the reform: this statistical technique is called a difference-in-differences analysis.

¹⁴Chemin (2007) assembled a panel data set between 2001 and 2003 about the performance of 875 district court judges from the annual reports published by the Lahore and Peshawar High Courts and the High Courts of Balochistan and Sindh. See Table 1 of Chemin (2007) for the source, description and summary statistics of the variables used.

¹⁵although none has been brought to the attention of the author.

¹⁶This figure was obtained by counting the transitions from unemployment to self-employed or entrepreneur and from employment to self-employed or entrepreneur from the 2003 Labor Force Survey of Pakistan, an accurate measure that does not include business owners who might have closed an existing business and opened a new one, which would affect employment ambiguously.

¹⁷To relate entry rates to economic growth, I used the (already described) 2007 World Bank Group Entrepreneurship Database to measure, in a simple panel data analysis with country fixed effects, robust standard errors clustered at the country level with 189 observations, the correlation between entry rates and log GDP per capita obtained from the World Penn Tables. This analysis indicates that a 1 percentage point increase in entry rate is associated with an increase in GDP per capita of 0.43

percent (Data found at www.ifc.org/ifcext/sme.nsf/Content/Entrepreneurship+Database).

¹⁸Pakistan Country Assistance Strategy 03-05, annex II, p.9

¹⁹A pilot project to computerise customs, if replicated, should further streamline the clearance process in a near future.

²⁰Pakistan-European Community Country Strategy Paper for 2007-2013, p.8

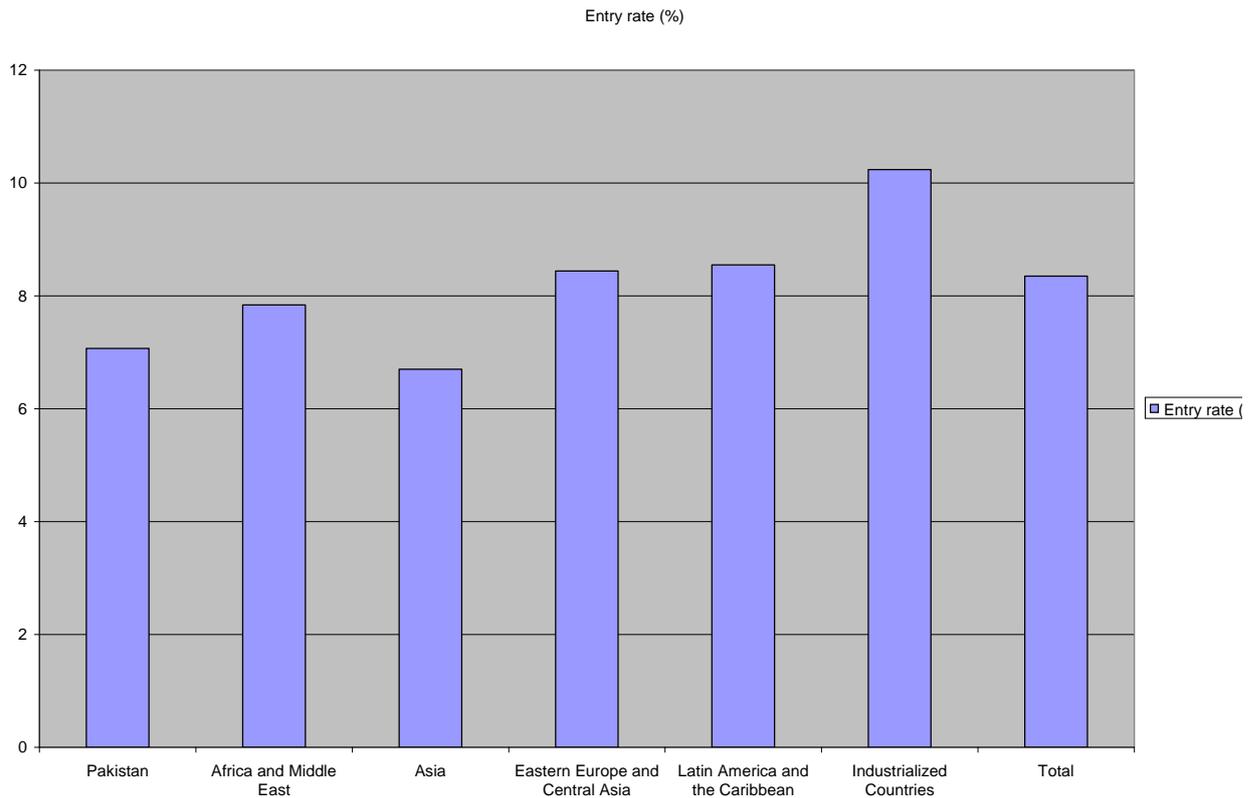


Figure I: entry rates (calculated as new registrations of companies as a percentage of total lagged (previous year) registered businesses). (Source: the 2007 World Bank Group Entrepreneurship Survey).

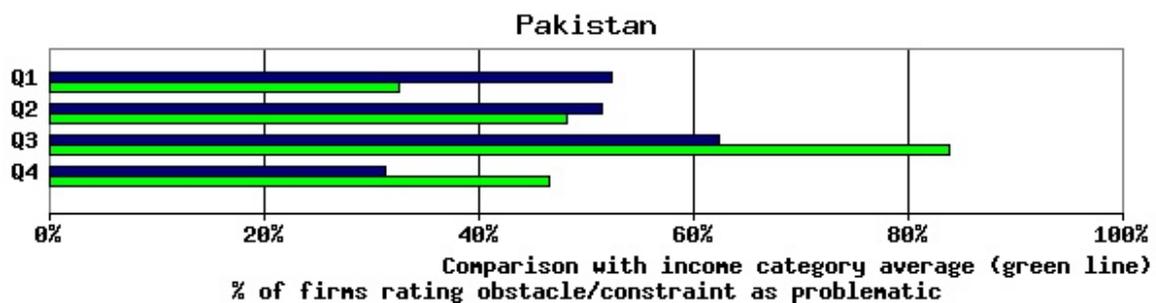


Figure II: Perceptions of the judiciary from The World Business Environment Survey (WBES) 2000, The World Bank Group. Q1: How problematic are obstacles in the business environment in the following areas? Functioning of judiciary; Q2: How would you rate the quality and efficiency of the following public services? Judiciary; Q3: How often do you associate the following descriptions with the court system in resolving business disputes? Quick; Q4: To what degree do you agree that the legal system will uphold contract and property rights?

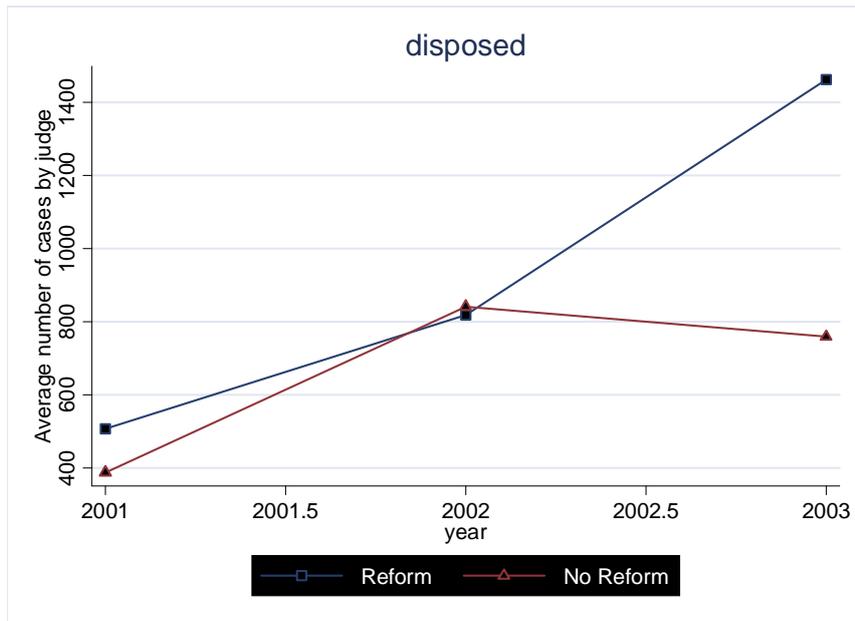


Figure III: Mean Number of Cases Disposed in Treated Districts (Square) as Opposed to the Mean Number of Cases Disposed in Non-Treated Districts (Triangle) Between 2001 and 2003 (Source: Chemin, 2007).

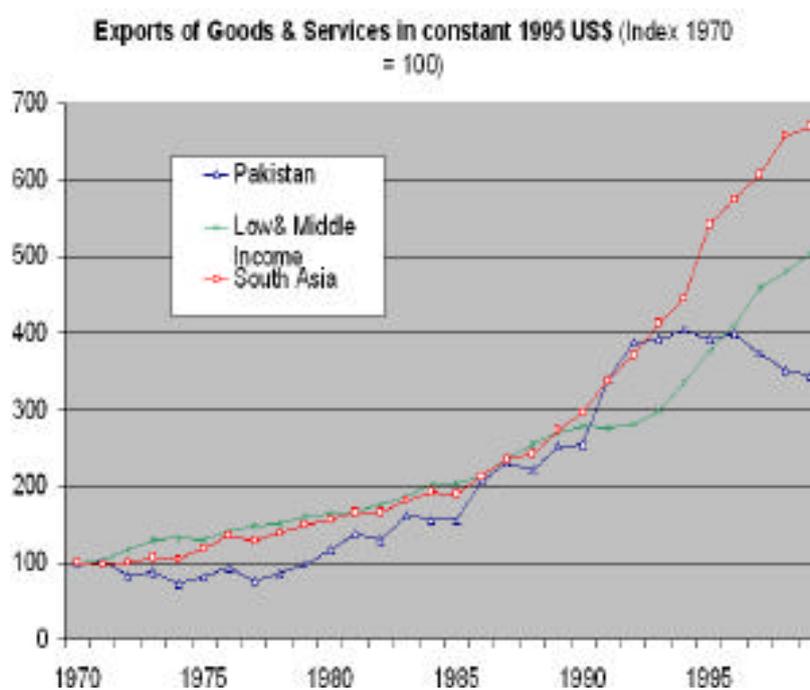


Figure IV: Pakistan export performance (Source: Pakistan Country Assistance Strategy 03-05, annex II, p.5)