USAID Small and Medium Enterprise Activity

Development of Revised SME Policy of Pakistan

Deliverable No. 7
Final Policy Report

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Data Page

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ABSTRACT

The Small and Medium Enterprise (SME) final policy report provides a comprehensive analysis and set of recommendations for the revision of the SME policy 2007, in light of both economic and constitutional changes of the past decade. The policy recommendations are based on evidence gathered from a field survey of over 200 SMEs and interviews with relevant private and public sector entities. In formulating these recommendations, the experience of other countries and best practices in the domain of SME policy have been taken into consideration. The objective of the policy is to trigger private sector growth, which is geographically and socially inclusive, generate countrywide employment, improve business competitiveness and increase exports. The guiding economic principles behind the suggested interventions are to rectify market failure arising from externalities and information asymmetries present in markets such as skills and credit, reduce cost of doing business by improving the regulatory infrastructure, and ease coordination problems arising from the lack of supply of critical infrastructure such as roads, energy, Information and Communications Technology (ICT) services etc. impeding SME growth. The policy framework is based on two central pillars – **reforming the policy and regulatory environment** and **addressing SME market constraints**, both demand and supply side. Within the policy and regulatory environment, the focus is on creating enabling and business friendly policies and regulations for SMEs to flourish. Demand side constraints look at issues of market access and the role of public procurement in creating demand for SME products and services. Supply side focuses on Business Development Services (BDS), Entrepreneurship and Innovation, Credit and Skills market and Infrastructural provisions necessary for SME growth. The policy puts forward a revised SME definition at the outset and recommends an Institutional Framework for implementation at the end.

ACRONYMS

ADR	Advances to Deposit Ratio
AHAN	Aik Hunar Aik Nagar
AJK	Azad Jammu and Kashmir
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BDS	Business Development Services
BDSF	Business Development Services Fund
BDSP	Business Development Service Provider
BPC	British Patient Capital
BSCIC	Bangladesh Small & Cottage Industries Corporation
CAD	Canadian Dollar
CASME	China Association of Small & Medium Enterprises
CCI	Chamber of Commerce and Industry
CGS	Credit Guarantee Scheme
CMI	Census of Manufacturing Industries
CPEC	China-Pakistan Economic Corridor
CPI	Consumer Price Index
CV	Curriculum Vitae
DTRE	Duty and Tax Remission for Exporters
EAC	Economic Advisory Council
EDF	Export Development Fund
ELPRO	Electronic Procurement System
EOBI	Employees Old-Age Benefits Institution
EPZ	Export Processing Zone
ESPD	European Single Procurement Document
EU	European Union
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FGD	Focus Group Discussion
FTA	Free Trade Agreement
GB	Gilgit-Baltistan
GBP	Great British Pound
GCI	Global Competitive Index
GDP	Gross Domestic Product
GEDI	Global Entrepreneurship and Development Institute
GNI	Gross National Income
GOP	Government of Pakistan
GST	Government Sales Tax
GVC	Global Value Chain
HR	Human Resource
HRD	Human Resource Department

ICT	Information and Communications Technology
IFC	International Finance Corporation
INSMED	Institutes of Small and Medium Enterprise & Entrepreneurship Development
ISA	Individual Savings Account
IT	Information Technology
KKH	Karakoram Highway
KOSGEB	Small & Medium Industry Development Organization
KPI	Key Performance Indicator
KPK	Khyber Pakhtunkhwa
LC	Letter of Credit
M&E	Monitoring and Evaluation
MFB	Microfinance Bank
MFN	Most Favored Nation
MIT	Massachusetts Institute of Technology
MNC	Multinational Corporation
MPI	Multidimensional Poverty Index
MSME	Micro, Small and Medium Enterprise
MSS	Ministry of SMEs and Start-ups
NAB	National Accountability Bureau
NASME	National Association of Small and Medium Enterprises
NAVTTC	National Vocational & Technical Training Commission
NCB	National Credit Bureau
NEPRA	National Electric Power Regulatory Authority
NIRC	National Industrial Relations Commission
NSIC	National Small Industries Corporation
NSS	National Skills Strategy
NSW	National Single Window
NTB	National Training Bureau
OECD	Organization for Economic Co-operation and Development
OICCI	Overseas Investors Chambers of Commerce & Industry
OIOO	One In One Out
PBC	Pakistan Business Council
PCSIR	Pakistan Council of Scientific and Industrial Research
PECO	Pakistan Engineering Company
PESSI	Punjab Employees Social Security Institution
PHA	Parks and Horticulture Authority
PIEDMC	Punjab Industrial Estates Development and Management Company
PKR	Pakistani Rupee
PPP	Public Private Partnership
PPRA	Punjab Procurement Regulatory Authority
PRA	Punjab Revenue Authority
PRMP	Punjab Resource Management Program
PSDF	Punjab Skills Development Fund
PSIC	Punjab Small Industries Corporation
PSLM	Pakistan Social and Living Standards Measurement

PSQCA	Pakistan Standards and Quality Control Authority
PTA	Preferential Trade Agreement
P-TEVTA	Punjab-Technical Education & Vocational Training Authority
PVTC	Punjab Vocational Training Council
R&D	Research and Development
RIA	Regulatory Impact Assessment
SBP	State Bank of Pakistan
SDC	Skills Development Council
SECP	Securities and Exchange Commission of Pakistan
SEIS	Seed Enterprise Investment Scheme
SEZ	Special Economic Zone
SGD	Singapore Dollar
SKU	Stock Keeping Unit
SME	Small and Medium Enterprise
SME Corp	Small and Medium Enterprise Corporation
SMEDA	Small and Medium Enterprise Development Authority
SRO	Statutory Regulatory Order
STEM	Science, Technology, Engineering and Mathematics
TA	Trade Association
TDAP	Trade Development Authority of Pakistan
TEVTA	Technical Education & Vocational Training Authority
TFU	Trade Facilitation Unit
TIC	Technology Innovation Center
TNC	Transnational Corporation
TOR	Terms of reference
TUSDEC	Technology Upgradation and Skill Development Company
TVET	Technical and Vocational Education and Training
UAE	United Arab Emirates
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
US	United States
USD	United States Dollar
VCC	Venture Capital Company
WTO	World Trade Organization

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EXECUTIVE SUMMARY

The final policy report (henceforth 'the report') presents policy recommendations, and supporting analysis for a comprehensive revision of the SME policy 2007. The objective of the revised SME policy is to create an enabling environment for small and medium-sized enterprises to grow. More specifically the policy aims to improve firm competitiveness and exports and generate countrywide employment that is socially and geographically inclusive.

The need for a policy revision arises due to the political and administrative devolution introduced by the 18^{th} Amendment to the constitution of Pakistan, and major shifts in the economic landscape in the past decade. Provinces now enjoy much greater autonomy over administrative and economic policy than in 2007. The revised policy and the suggested institutional framework for its implementation keep in view the challenges of inter- ministerial coordination - between the federal and provincial domains and across provinces - brought about by devolution.

The signing of the Pakistan-China Free Trade Agreement (FTA) in 2007, a severe energy crisis since 2008, which still persists in non-industrial areas, and the potential vent for growth arising from the China-Pakistan Economic Corridor (CPEC) are some salient examples of economic changes post 2007. Also, since 2007, there have been major innovations in digital technology which have transformed the market place. Digital platforms such as e-commerce and innovations in financial technology (fintech) are fast changing the nature of transactions of goods and services providing access to both international and domestic markets. These changes have also created opportunities for innovative business ideas and entrepreneurship. The policy recommendations take into account the opportunities and challenges brought forth by the digital revolution to a developing country like Pakistan.

The formulation of the report is evidence based, the primary source of which is the quantitative data and the rich qualitative information obtained from a structured survey and focus group discussions with more than 200 SMEs, from different sectors, across the country. This information helped corroborate and update information on the most binding constraints to SME growth identified in the literature. Some of the main constraints are high energy prices and continued outages of electricity and gas in non-industrial areas, lack of skills, technology and access to formal credit, disproportionate regulatory burden on small firms and the predation and rent seeking of government departments and officials. The SMEs also identified and prioritized the services and facilities they require to improve their profitability and competitiveness. Additionally, the report draws on consultative sessions with relevant provincial and federal departments and agencies, analyses of datasets, an extensive review of literature and a study of the experiences of other countries. Finally, the report is informed by discussions with industry leaders, relevant experts and economists working in the area of SME development.

In drafting the policy recommendations, certain fundamental principles have been kept in mind. Firstly, the interventions suggested are designed to correct market failure arising particularly from externalities and information asymmetries present in markets such as skills and credit. Secondly, the policy aims to reduce the cost of doing business by improving and rationalizing both the regulatory environment and the interface of firms with the government. Thirdly, the policy addresses coordination problems between public investments and private sector growth. These problems might arise due to the lack of supply of critical public goods and services impeding the formation of SME clusters and retarding their growth. Fourthly, the lack of resources and capacity of the government has been taken into consideration while drafting the policy. Therefore, emphasis has been given to interventions that are cost-effective and leverage private sector resources and services wherever state capacity is weak or non-existent. Fifthly, while the suggested policy interventions aim to lower the disproportionately high costs faced by small firms, they are also designed to create a supportive environment to encourage the creation and success rate of fast growing and innovative enterprises – the "gazelles". Finally, the policy is inclusive in terms of both geographical coverage and gender. There are concessional terms provided to women led businesses in order to achieve a better gender balance.

The structure of the report follows a simple framework resting on two pillars. The first pillar is the external macro policy and regulatory environment facing SMEs and the second is the internal market conditions in which SMEs operate. Evidence suggests that SMEs are constrained because of the macro policy and regulatory environment, and because of cross cutting market constraints – both supply and demand side issues common across different sectors. Therefore, the report first reviews the overall macro policy (trade, monetary and fiscal/tax) and regulatory environment, and then focuses on the horizontal (non-sector specific) demand and supply side constraints.

Within the demand side, the report covers Market Access and Public Procurement. On the supply side a range of relevant issues are addressed, from Business Development Services (BDS), Entrepreneurship, Credit and Skills market to Physical Infrastructure. As SME definition is a fundamental issue, the first section proposes a simple and usable definition. Finally, as the suggested policy interventions span a range of departments and ministries at both the federal and provincial level, they require seamless coordination for effective implementation. Therefore, the report has a section devoted to framing an institutional mechanism for inter-ministerial coordination and a revised role of the Small and Medium Enterprise Development Authority (SMEDA), as the apex nodal organization representing the interests of the SMEs. The concluding section of the report collates and synthesizes the main policy recommendations into an announceable Policy document for the Government of Pakistan. The following are brief descriptions of each section and their salient policy recommendations.

SME Definition

The first section sets the stage by presenting a definition for SMEs. The new definition is novel in two important ways. Firstly, it defines SMEs on the basis of sales turnover alone, rather than in combination with employment or fixed assets. Definitions that use employment as a criterion typically need to set different cut-offs for different types of economic activity (e.g. services, trade, construction) to account for variation in employment intensity. In addition, full-time equivalents need to be calculated to deal with seasonal, contractual and part-time employees. Most importantly, giving preferential treatment to small firms as defined by employment (or fixed assets), creates disincentives for labor (or capital) intensive firms. Using fixed assets in the definition has the additional disadvantage of requiring external validation.

Sales revenue, in contrast, is a relatively simple and practical measure of size. Sales revenue data is already reported for tax purposes, so imposes no additional administrative costs for firms or for government agencies. It does, however, remain an imperfect indicator of size, primarily because it suffers from measurement and reporting errors, and overestimates the size of firms that trade or outsource more. However, measurement and reporting errors are no less severe than in other variables. Additionally, while there may be better indicators of size, e.g. value-added, these are unrealistic to calculate for each firm. There is, in the end, a trade-off between practicality and sophistication. Sales revenue manages to strike a reasonable balance between the two.

The second novel aspect of the definition is that it proposes a separate category for new firms. Recent literature on the economic impact of small firms suggests that it is young firms, rather than small firms per se, that are more likely to be “gazelles” or “transformational entrepreneurs” i.e. have strong growth and employment potential. This categorization distinguishes them from small “subsistence” entrepreneurs that do not typically ever grow beyond employing two or three people. Data from the Economic Census (2005), for example, shows that over 90 percent of Pakistani firms employ fewer than five people even two decades after they were established. This is also in line with international evidence (see for example Lerner & Schoar (2010)).

A separate category for new firms is an important step towards providing a favorable incubating regime for the creation and success rate of new firms. These “new” firms are defined as those less than five years of age, with a sales turnover up to Pakistani Rupee (PKR) 50 million. The five-year clause allows for a screening out of subsistence entrepreneurs – if they do not grow, they will run out of the time limited support. Transformational entrepreneurs will either fail and drop out, or will grow and graduate to the small and then medium categories, which offer decreasing levels of support. There is, therefore, more intensive support offered to this category, with an inbuilt sunset clause.

In addition, the proposed definition classifies registered, independent enterprises into two further sub-categories: “small” and “medium”. Small firms are defined as those that have a sales turnover between PKR 6.5 million and PKR 100 million. Medium firms are those that have a sales turnover between PKR 100 million and PKR 650 million. A residual category of “micro” firms is defined as those firms with a turnover below PKR 6.5 million, whether or not registered. Incentives, such as for tax and public procurement, are not extended to micro firms.

These thresholds and categories were determined through an analysis of Pakistan’s size distribution of firms, benchmarking with comparable countries, a literature review of academic work on SMEs, discussions with SMEs in which they were asked the size at which the size-related disadvantages taper off, and with institutions that work with SMEs, such as Karandaaz and the National Incubation Centre.

Any support to small firms, regardless of how they are defined, runs the risk of disincentivizing firms from growing. The ideal support sufficiently compensates firms for the disadvantages of being small, without overcompensating. This level of support is not known in advance. Therefore, the approach recommended is to evaluate frequently and rigorously, so that policy parameters can be fine-tuned iteratively.

Macroeconomic Policy

As a stable and business friendly macro policy environment is a necessary condition for businesses to grow, the second section of the report is on macro policy and SMEs with a focus on trade, exchange rate, interest rate and taxation policy. Pakistan's export performance has remained consistently poor for the last five years, resulting in a widening trade deficit that reached United States Dollar (USD) 38 billion in 2017-18. The trade policy recommendations aim to boost exports, especially of SMEs. These recommendations are in line with those suggested by the Economic Advisory Council[1] (EAC) on exports and are also based on the evidence gathered from the survey of exporting clusters. The recommendations include giving complete tariff exemption on imported raw material and intermediate goods of exporting SMEs and SMEs that are vendors to exporting firms. For SMEs which normally do not import in bulk, there is a recommendation to establish Bonded Warehouse facilities. Additionally, as the existing Duty and Tax Remission for Exporters (DTRE) scheme is quite complex, it is recommended that procedure for duty exemptions be simplified. As garnered from interviews and surveys, SME exporters face severe working capital constraints because of non-payment of sales tax refunds and duty draw backs. It is recommended that the State Bank of Pakistan (SBP) should release these funds immediately. In terms of operational issues, firms find customs procedures to be cumbersome and costly. It is recommended that these procedures be improved through the expeditious implementation of the Single Window System which is currently under development. A strong advocacy role of SMEDA is required in the Commerce Ministry and in the Customs department to implement these policy recommendations.

The recommendation on exchange rate and interest rate policy is to have stability in both variables. In particular, it is recommended that the exchange rate be competitive, and not be artificially appreciated. A strong advocacy role of SMEDA is recommended at the State Bank on both monetary policy and exchange rate management.

A favorable policy that does not stifle SME growth is a central consideration in devising taxation recommendations. The tax structure of Pakistan is extremely narrow with a reliance on regressive indirect taxes. The frequency of tax payments is high, adding to the cost of compliance for SMEs. There are also issues of double taxation, particularly for services, because of lack of harmonization of provincial taxes. Finally, the interface of businesses with tax authorities is burdensome for small firms as they cannot afford accountants or tax lawyers to respond to frequently issued tax notices. A general recommendation on tax policy is to broaden the tax base and reduce the frequency of tax payments.

For SMEs specifically, it is also proposed that the announced policy to reduce corporate income taxes for firms with a turnover of less than PKR 250 million from 25 percent to 20 percent by 2023 is extended to firms with a turnover less than PKR 650 million (medium sized firms). For small firms with a turnover of less than PKR 100 million (as per proposed definition of small firms) a presumptive tax option can be offered in which they pay 8 percent of their revenue. This scheme would ease tax compliance and filing process for small firms who would not have to keep detailed books of accounts. In addition, there are a set of recommendations on facilitating equity finance for entrepreneurs: Firstly, individual savings of up to PKR 2 million can be invested in stocks and shares, with up to PKR 200,000 tax free dividend allowance and no capital gains on increases in the value of stocks and shares. Secondly, a system of tax relief for corporate investors that channel funds to incubators, accelerators and other venture capital and business angel activity is proposed.

1 The Economic Advisory Council is an advisory body on economic policy to the federal government. The Council has various sub-committees and working groups including one on Exports and SMEs.

A final set of recommendations is aimed at encouraging the development of SMEs that are vendors to multinationals. These include making existing tax breaks for multinationals (for example under SEZs) conditional on sourcing products, services and labour locally. In addition, expenses incurred in developing the capacity of SMEs (e.g. through licensing, labour training, technology upgradation) are to be made tax deductible.

It is recommended that the process of filing tax returns be simplified and made more transparent to improve compliance and curb harassment of tax payers. There is also a need for an SME facilitation center at Federal Board of Revenue (FBR), enabling them to provide direct, personalized and timely guidance to taxpayers on compliance.

Regulatory Interface

The section on regulation addresses one of the most critical impediments to SME growth – their interface with government. SMEs perceive government departments, such as tax, labor, and sector-specific regulatory bodies, to be non-facilitative and predatory. SMEs express a preference to stay small so that they can remain off the "radar" of government departments; in other words the interface with government acts as an impediment to growth. Importantly, SMEs recognize regulation as a necessity, and are willing to comply with necessary regulation. Their protest is against outdated and inappropriate regulations, and against non-business friendly implementation, including rent-seeking.

In order to address these issues, a Regulatory Guillotine is proposed, which is a systematic method for rapidly reviewing and streamlining a large volume of rules and regulations. It invites every department to answer four questions about every rule and regulation that it imposes: Is it legal? Is it required? Is it business friendly? Are the fees reasonable? The same exercise is then undertaken by private sector stakeholders and independent evaluators. The answers allow for a complete stock taking of existing regulations, the removal of redundant regulations and the simplification of required regulations that are excessively burdensome. The end product is also a legal registry of rules and regulations, outside of which departments are not authorized to expect compliance. This plays the additional role of information provision to firms, addressing the problem of insufficient information reported by businesses. The Regulatory Guillotine has been tested in several countries, and has been instrumental in improving their ease of doing business.

In addition, a one-in-one-out system is proposed for keeping the regulatory burden in check and forcing government to evaluate costs to business when proposing regulations. This requires the government to assess the costs of compliance of the proposed regulation and remove regulations with an equivalent cost at the same time.

Other measures that could be added include regulatory tiering, by which regulations such as reporting and accounting requirements are exempted for small non-incorporated firms and new firms. Several measures are also suggested for easing the process of inspections and compliance checking, such as offering support and training, self-inspection, and a system of clear communication of compliance requirements to SMEs.

Market Access

SMEs tend to face major impediments in marketing and selling their products internationally while those located in small towns and more remote areas have problems accessing the main local markets within the country. Lack of information about markets, logistical costs, funds for marketing, packaging, standardization and certification are all key constraints impeding the ability of SMEs to export and for some to sell locally. It is recommended that Trade Development Authority of Pakistan (TDAP) should fully utilise the special quota for SMEs, particularly for women-led businesses, in international trade fairs and exhibitions. This can be done by developing greater awareness of the TDAP facilities amongst women entrepreneurs. For women led SMEs in small town and cities in Baluchistan, KPK and GB, the existing subsidy by TDAP for participating in such exhibitions and fairs should be increased. The funding for this activity can come from the Business Development Services Fund (BDSF) under the institutional framework being proposed for SME support (see section 12 on Institutional Framework). The BDSF may secure seed funding from the Export Development Fund (EDF) and also leverage donor assistance. To improve domestic market access, particularly for cottage and small firms in rural areas and remote regions of the country, it is recommended that regular exhibitions and trade fairs should be organized in major cities. Provincial SMEDA offices and AHAN (Aik Hunar Aik Nagar)2 can jointly organize these fairs and exhibitions. It is also recommended that permanent Emporiums be established to exhibit and market products of cottage and small firms from all provinces and regions of Pakistan. Stalls in these Emporia could be rented at a subsidized rate and on a rotational basis to registered cottage and small firms. Moreover, a cluster-based marketing strategy needs to be adopted where incentives are provided to product associations to set up sector specific export marketing companies. SMEDA can either part fund the setting up of these companies or provide matching grants for marketing, packaging, branding and quality certifications etc. Moreover, to improve product quality and enhance exports it is imperative to have domestic standards and certification through the implementation of national quality standards and establishment of internationally recognized certification/labs. Financing of these initiatives can come from the proposed BDSF.

Market access can also be enhanced through greater coordination between SMEs and between SMEs and larger firms looking to outsource products and services to SME vendors. The proposed SME Portal (explained in more detail in the institutional section) can facilitate this.

Given rapid changes in technology and the emergence of digital platforms, it is suggested that the recommended e-commerce regulatory framework being developed by the Ministry of Commerce be implemented. This would create the space for Online market places to be established which would significantly increase both domestic and international market access for SMEs, particularly those owned by women. Furthermore, an appropriate regulatory environment is required for local payment gateways or fintechs to be established. It is recommended that SMEDA facilitates training provision to SMEs in the use of digital platforms through the Business Development Services Fund (BDSF). Finally, SMEs can become part of Global Value Chains (GVCs) through sub-contracting relationships with local Multinational Corporations (MNCs). For that, along with other incentives, specific tax breaks can be provided to MNCs for engaging with local vendors. Such sub-contracting would lead to technology transfer, labor training and improved management practices of local firms. SMEDA is required to play a strong advocacy role with the Federal Board of Investment to negotiate greater engagement of MNCs with vendor SMEs.

2 AHAN - Aik Hunar Aik Nagar (one village one craft) is a section 42 company established in 2007 under the administrative control of the Ministry of Industries and Production, GOP. The company aims to promote and develop micro and small non-farm businesses (local crafts and wares) in rural areas across the country.

Public Procurement

The significance of opening up public procurement to SMEs through removal of systemic biases and lowering of participation costs has been widely recognized and is being pursued as an important policy tool worldwide. Public procurement, which in Pakistan's case is almost 20 percent of Gross Domestic Product (GDP), represents the state's purchasing power that can be strategically employed to pursue national priorities in diverse policy areas.

The report proposes three major recommendations for leveraging public procurement for SMEs. First, it is important to remove the systemic hurdles that limit the possibilities of SMEs' participation in public procurement process. Specific examples of these include procurement rules relating to non-splitting of contracts, requirements of performance and security guarantees and preferences accorded to firms with high turnover and large size. To remove such inherent biases in the system, it is recommended that a thorough review of existing rules be undertaken and necessary modifications be made on its basis. The second set of recommendations aims to address information asymmetries adversely affecting SMEs. The development of an electronic database of SMEs (excluding micro-enterprises) and an e-portal for centralized public procurement are recommended. This would apprise the public sector of an SME's profile and lower the SME cost of bidding. Third, it is important to highlight that public procurement can also help ease SME access to finance. The technical and financial evaluation of an SME's profile, and information about a successful bid can be used by private financial institutions to provide credit to SMEs. It is therefore recommended that to enhance the utilization of public procurement incentive, information sharing between public organizations and banks be ensured.

Business Development Services

This section covers aspects related to business development services, and finds that more customized and intensive trainings and services are more effective, as are incubation programs that include networking and mentorship. These services have generally been shown to generate benefits in excess of what they cost. However, the private sector market for BDS has not emerged naturally due to information failures, both because firms do not know the value of the services, and also because there is poor information on their quality and availability. Recommendations are based on the principle of supporting the development of private sector markets. This includes matching grants to SMEs that take these services (funded through the BDSF), with freedom to choose between BDS providers that are registered with SMEDA. It is recommended that a more substantial matching grant be provided for women owned businesses. An online, publicly available rating system for BDS providers and courses is suggested, similar to successful models in ride-hailing and accommodation booking services that also address information problems. An online portal (the "SME Portal" detailed in the institutional section) is also suggested as a means to communicate need for new training to potential BDS developers, and for BDS developers to access information about the location and requirements of SMEs. Finally, it is recommended that SMEDA undertake a comprehensive needs assessment for business development services, and partner with financial and other institutions to provide technical support to BDS providers to develop appropriate services.

Entrepreneurship

The report places considerable emphasis on the development of an entrepreneurial ecosystem. The most critical missing ingredient for this is the availability of risk capital. Recommendations for this include the adoption of the Limited Liability Act by provinces (as partnerships fall within the provincial domain). This allows a general partner in a non-incorporated firm to take on an equity partner, offering limited liability to them while retaining unlimited liability for the general partner. The current system forces firms to corporatize in order to raise equity, which imposes a disproportionately heavy burden of administration and reporting for a start-up. Other recommendations are to create a legal framework for crowdfunding, and appropriate rules at Securities & Exchange Commission of Pakistan (SECP) for venture capital funds to register. The current rules require them to register as non-financial institutions, which has so far precluded the registration of any on-shore venture capital fund. Additional ways to encourage the availability of equity finance include tax incentives to channel individual and corporate savings into equity finance.

The second critical impediment to entrepreneurship is inappropriate regulation. This takes several forms: taxation, public procurement rules, immigration and visa policies, intellectual property rights enforcement, bankruptcy laws, regulations for new business models, and university rules that prevent innovations originating in their labs from being commercialized by existing faculty. Low and uniform taxes, a sandbox approach to regulation, public procurement targets, and options for restructuring debt before liquidation proceedings are amongst the suggestions for addressing this. Accelerators and incubators are also useful for supporting “gazelles”. A private sector led model is suggested, with government facilitating rather that creating incubators and accelerators itself. This can be through tax incentives for corporates, and through provision of infrastructure. It is recommended that incubators and accelerators keep a portion of reserved seats for women. Lastly, school and university linkages are explored, by which entrepreneurial culture can be fostered in the formal education system from an early age.

Credit

Access to suitable credit is critical for SMEs, without which some fail to start, while others are unable to grow. In the survey of firms conducted, lack of formal credit was identified as one of most serious constraints to growth across all sectors. In the absence of formal credit, SMEs tend to rely on retained earnings for both working capital requirements and investment needs. At the macro level, the Advances to Deposit Ratios (ADRs) for commercial banks in Pakistan have increased above 50 percent to PKR 7,310 billion, however, the amount of credit to SMEs still hovers close to PKR 400 billion with under 200,000 borrowers (State Bank of Pakistan, 2018a). Moreover, a majority of those who are utilizing credit are usually the relatively large firms. The disbursement of credit to small firms is restricted due to a number of reasons including, capacity deficiencies and the informal way of recording business transactions, lack of collateral and poor credit history of some firms within the sector. All these create information gaps and therefore banks perceive advancing loans to small firms as being very risky. The recommendations made in the report address these credit market failures due to information asymmetry and moral hazard. The policy supports a comprehensive implementation of the State Bank 2017 Policy on SME Credit. The recommendations posit strengthening the role of SMEDA to initiate an SME registration and information gathering exercise leading to credit scoring and the setting up of a credit bureau. It also requires SMEDA to advocate and lobby commercial banks to advance credit to SMEs. The policy proposes immediate steps such as offering back to back Letters of Credit (LCs) for exporters and operationalizing the electronic registry of movable assets for all sectors. The policy supports the Federal Government target of enhancing SME credit to PKR 1.8 trillion in five years which is expected to increase the number of borrowers to approximately one million (State Bank of Pakistan, 2017a).[3] State Bank currently has a credit refinance scheme at 0 percent for women. The policy supports greater utilization of this facility.

Skills and Human Resource

Quality human capital results in high growth across all sectors and SMEs are no exception. Skilled and literate labor is also a pre-requisite for technology adoption and innovation in SMEs. The provision of skills by the public sector vocational training institutions in Pakistan has not been demand driven, with training and curriculum that has little relevance to the needs of the private sector, and especially of SMEs. This well documented problem was corroborated in the SME focus group discussion sessions across the country. The institutional structure of skills provision is complex and convoluted with inter province, intra province and federal-provincial coordination issues resulting in overlaps, inefficiency and wastage of resources. Moreover, most skill providing bodies have no direct representation of SMEs. The 2019 SME Policy recommends SMEDA to be made part of the Boards of all key skills providing bodies across the country to represent SMEs. The policy also recommends greater use of industry partnerships to design specific and relevant training programs. The Punjab Skills Development Fund (PSDF) model should be explored and if found feasible may be replicated in other provinces to improve the outcomes of the Technical and Vocational Education and Training (TVET) market. The skills sector suffers from severe coordination and information failures. The provincial and federal bodies and intra-province departments largely remain disconnected. Moreover, the job placement services are not available in any meaningful way. The report recommends institutional clarity, strengthening of coordination and further improvement in the job portal set up by the Skilling Pakistan initiative. Moreover, the analysis suggest a need for increasing women centric training courses and scaling up initiatives such as 'Job Assan' at the Punjab Commission for Status of Women (PCSW) that are focused on linking women with potential employers.

Infrastructure

The focus group discussions, held as part of this SME Policy revision exercise,indicated that reliable supply of energy at affordable rates continues to be a major constraint faced by the SMEs. The operation and management of industrial estates and adequate road network were also identified as key constraints across the country. In addition, there are region specific infrastructure gaps, such as Internet bandwidth and supply of electricity to off-grid areas in Gilgit Baltistan.

Accordingly, the infrastructure related recommendations have been segregated into three broad categories. To provide affordable and reliable electricity, it is recommended that industrial sector be offered block tariff regime and off-grid rural SMEs be provided with clean energy from alternate sources such as solar or wind energy. To ensure a targeted approach to deal with overall infrastructural issues such as high rents, market access and energy shortage, it is recommended that SMEs in the manufacturing sector be incentivized to locate in a cluster through creation of industrial estates or Special Economic Zones (SEZs). As nine SEZs are planned under the CPEC portfolio, it is important to focus on their direct benefits

3 The target has been announced by the Federal Government and was shared by the State Bank Team present in the First Steering Committee Meeting on the SME Policy.

for SMEs such as location and infrastructure support besides the indirect ones from agglomeration economies. Additionally, the Chinese experience of successful management of SEZs can provide beneficial insights for planners and managers of SEZs in the long term. In the short term, to ensure better planning and management, it is recommended that industrial estates or SEZs be developed using a Public-Private Partnership (PPP) model. The Punjab Industrial Estates Development and Management Company (PIEDMC) model of Punjab has been found to be successful and can be replicated in other provinces. To eradicate the speculation issues and to ensure that the enterprise performance meets announced Key Performance Indicators (KPIs), it is recommended that the industrial estates use the land leasing model instead of land sales. For roads, it is recommended that an extensive spatial strategy on the pattern of Punjab province be developed on a national basis to map existing and planned industrial clusters and trade corridors. Planning of new roads and industrial estate using this information shall yield better utilization of resources.

Institutional Framework

This particular section of the report is arguably the most important as it outlines an Institutional Framework to address the challenges of SME policy implementation in a devolved government structure. The implementation shortcomings of the 2007 SME policy were, in part, due to an inadequate framework for implementation and capacity gaps at key levels of the government. These shortcomings can broadly be clubbed into three categories: those concerning the capacity (or lack thereof) of SMEDA; a lack of coordination among important government and private sector stakeholders; and institutional conflicts and a lack of clarity over SME-specific mandates.

To address the issue of coordination failures and lack of SME voice in government, the report recommends establishment of the SME Council to lead the agenda for SME development and ensure effective implementation of the SME Policy 2019. The SME Council will be chaired by the Minister for Industries reporting directly to the Prime Minister. SMEDA will act as the secretariat of the SME Council and will hold quarterly meetings or special meetings as required. The SME Council will report progress on policy implementation to the cabinet once every six months and will ensure that necessary directives are issued. The Council shall be supported by provincial working groups headed by Secretary Industries of each province. These working groups shall coordinate with SMEDA to follow up policy implementation at the provincial level and to raise SME issues to the Council on behalf of the provinces.

The policy recommends that the capacity of SMEDA be upgraded within a five-year period. Key steps in the upgradation process include a comprehensive institutional and HR review. This would also entail the building of specific capacities especially those relating to Fund/Grant Management. The policy also recommends the creation of PKR 30 billion endowment fund for SMEDA activities and a grant fund of PKR 1 billion to be established to fund different components under BDS (Business Development Services Fund (BDSF)). Providing sustainable funding is an important part of the implementation plan for the SME Policy, as it addresses one of key bottlenecks faced by the last SME Policy. The endowment fund will allow SMEDA to manage its operational activities smoothly and the BDSF will allow the support programs for SMEs to be funded and evaluated independently, including the potential to leverage donor financing for the upgradation of the SME Sector. The institutional setup proposed allows for a robust, independent and transparent governance structure in managing the fund. The fund will receive resources from the Export Development Fund and Donor contributions. The SMEDA Act may be promulgated to strengthen SMEDA as an authority. The Chairman of the Authority shall be appointed from the private sector with requisite experience and understanding of the sector. The BDSF can function as an independent fund, registered as a Section 42 company with an independent board, along the lines of PSDF.

In addition, SMEDA can host an "SME Portal", on which SMEs can register for multiple purposes. This can include being a formal forum of consultation where SMEs can register their inputs on regulatory topics and access information on all business matters that require a government interface. This portal can also help, find other SMEs to partner with for larger orders, or to coordinate joint fixed investments and other collaborative projects, find suppliers or large firms that are looking for SME suppliers, find business service providers, see the feedback on business service providers and the services offered, provide ranking and feedback after taking a service and give inputs on missing services that are required to be collated and provided to potential new business service providers.

SME Policy Statement and Implementation Framework

The last section of the report is the ***SME Policy 2019***, which is essentially a collation of the main policy recommendations from each section of the report. The section has been drafted to serve as an independent SME Policy document to be submitted to SMEDA and the MoI. Therefore, the section begins with a Preamble giving an introduction to the structure of SMEs in Pakistan, their various constraints and the challenges and opportunities faced by them. It also outlines the evidence based methodology used in drafting the policy recommendations. This is followed by the Policy Vision and Mission statement, the Policy Principles and Framework and the Targets which the Policy sets out to achieve. Following this, the main Policy announcements are presented including the institutional and implementation framework. The policy implementation framework is summarized by a Policy Matrix which clearly specifies the responsible institution(s) for the main policy recommendations, indicates the resources from which the programs would be funded and also puts forth a timeline for implementation.

1. INTRODUCTION

This report puts forward a comprehensive revision of the SME policy 2007 in light of changes in Pakistan's economic and institutional environment over the last decade. It builds on two earlier deliverables: An inception report, which had a comprehensive literature review and data analysis; and a field report, which documented the findings from an extensive country-wide consultation with relevant public sector stakeholders and 200 SMEs. This report presents policy recommendations based on the evidence gathered, the review of extant academic and policy literature on SMEs, international experience and best practices.

The broader objective of the SME policy is to create an enabling environment for private sector growth. More precisely the policy aims to trigger private sector growth that is inclusive, generates countrywide employment, improves business competitiveness and increases exports. As SMEs constitute 99 percent of economic activity in the country, across manufacturing, services and agriculture, the SME policy is essentially a strategy for private sector development.

Since 2007, there have been fundamental changes in the government administrative landscape on account of the devolution of power to the provinces through the 18th constitutional amendment. Provinces today have much greater autonomy over administrative and economic policy matters than was the case in 2007. Therefore, the revision of the policy and the suggested institutional framework remains cognizant of the challenges of inter- ministerial coordination brought about by devolution. In fact, one of the main reasons behind the lack of implementation of the 2007 policy was the problem of coordination across various departments and ministries.

On the economic front, Pakistan is facing an acute fiscal and balance of payment crisis. Declining productivity and competitiveness across all major sectors have resulted in falling export revenues, exacerbating the balance of payments deficit. Additionally, a narrow tax base restricts fiscal space, which stymies the governments' ability to finance development and infrastructural projects. Chronic energy shortages and high tariffs, despite the recent increase in power generation, remain a top constraint to SMEs. Other issues, such as access to credit, availability of skilled labor and government regulatory infrastructure which spawns predatory and rent seeking behavior, remain the main concerns of SMEs across the country.[4] The policy interventions are therefore designed to address these constraints.

However, not all is bleak on the economic front – there are some significant opportunities and inherent strengths which can act as catalysts for SME growth. Pakistan has a young and growing population; if educated and skilled it could potentially help put the country on a high growth trajectory. A large and growing population also means a buoyant and attractive market which can be an impetus for domestic production and also for foreign firms to invest in the country. Foreign Direct Investment (FDI) can be leveraged by SMEs through sub-contracting to become part of global value chains. CPEC and the planned SEZs is an opportunity for joint ventures and sub-contracting with local SMEs in sectors such as garments, light engineering, auto parts and agri-processing. The designed interventions take into account these opportunities.

[4] For details on constraints see Field Survey Report of the project.

Like many other developing economies, Pakistan faces challenges of a fast-changing market place due to advances in technology brought forth by the 4th industrial revolution. Digital platforms such as e-commerce, on-line payment gateways and internet of things have reduced costs of trade and transaction, information and nature of products and services substantively. For the educated, computer literate urban population this offers tremendous entrepreneurial and economic opportunity. For those in rural areas and without access to education or technology, this means increased marginalization. At the same time the government regulatory infrastructure needs to keep pace with these technology shifts so as not to stifle the growth potential on offer. Therefore, the policy design for areas such as skills, BDS and entrepreneurship, attempts to harness and galvanize the positive but potentially disruptive role of technology and at the same time address issues of access and equity in the country.

The guiding principle behind the design of interventions is to correct market failure, reduce cost of doing business and resolve coordination failures particularly in the provision of infrastructure or public goods. These interventions are formulated keeping in mind their differential impact on SMEs and both resource and capacity constraints of the government. There is an attempt to come up with policies that have the highest bang for the buck, leveraging the private sector wherever possible. While it is understood that market failures, information asymmetries and regulations most often impact small enterprises more severely than others, it is also kept in mind that the drivers of private sector growth are the 'gazelles' – a select group of small innovative enterprises and successful medium and large sized firms.

The framework of the policy report rests on two fundamental pillars affecting SMEs – the overall macro policy and regulatory environment and the market conditions involving demand side issues and supply side constraints. The policy and regulatory environment is fundamental to SME growth as it determines the overarching business enabling environment. Within the policy and regulatory environment, the report covers trade, taxation, interest rate and exchange rate policy along with the regulatory infrastructure and its interface with the private sector in Sections 3 and 4. Following the analysis of policy and regulatory environment, the report moves onto the market – both demand and supply side. On the demand side, it covers market access and public procurement in Sections 5 and 6. Within market access, the role of digital platforms and FDI, exports and GVCs is discussed in detail. The supply side constraints revolve around BDS, credit markets, skills acquisition and finally physical infrastructure in Sections 7, 8, 9 and 10 respectively. Market failures in both the credit market and skills provision are highlighted. For credit, SBP's comprehensive policy for SMEs is analyzed and some additional interventions suggested. For skills, emphasis is given on the need to reform the existing public sector skills training infrastructure and link skills provision to industry demand. In Infrastructure, the disparity in energy provision across the country is identified along with issues of high cost of energy and resultant loss of competitiveness. The role of industrial estates in SME development is also looked at, with a recommendation to locate small, medium and large enterprise together – a hub and spoke framework similar to Japanese industrial parks. For BDS, the focus is on matching grants and support services to improve SME management, productivity and competitiveness.

Besides these two pillars on which the SME policy is based, the report starts with the most fundamental issue in Section 2 – defining" small" and "medium" enterprise. The definition proposed in the report is based on extensive stakeholder feedback, data analysis and benchmarking with definitions used across the world. The recommended definition differs from what is being used currently as a de facto definition. The proposed definition takes a much simpler approach by employing just one variable to define firm size – annual total turnover. The report also puts forward an Institutional Framework for implementation of the policy. It does that by prescribing a more autonomous and empowered role of SMEDA and a federal level SME Council to steer the implementation of the SME policy. It also lists the critical departments and industries for SME policy implementation and the role SMEDA would play as a coordinating body in the SME space.

The last and concluding section of the report is the SME Policy 2019 which collates the policy recommendations from each section of the report. The section has been structured to serve as an independent SME Policy document for SMEDA and the MoI. It begins with a Preamble giving an introduction to the structure, problems and challenges of SMEs in Pakistan and outlines the evidence based methodology used in drafting the policy recommendations. This is followed by the Policy Vision and Mission statement, the Policy Principles and Framework and the Targets which the Policy sets out to achieve. This is followed by the main Policy announcements which include the institutional and implementation framework. Finally, the policy implementation framework is summarized by a Policy Matrix clearly specifying the responsible institution(s) for the policy recommendations, the resources from which the programs would be funded and the timeline for implementation.

2. Developing an SME Definition

One of the fundamental objectives of this report was to provide a definition of SMEs that is comparable to international definitions, appropriate for Pakistan's context, and suitable for use by all stakeholders in Pakistan. The definition is important because it identifies those firms that need targeted interventions due to their size.

There are two important decisions to be made in developing the definition: the variables to use for the definition, and the thresholds to set below which a firm is classified as an SME. Several factors were explored in arriving at the definition: what the definition will be used for and its suitability for the purposes, the variables and thresholds that are used in other countries, suitability for Pakistan's size distribution of firms, and ease and simplicity – both for firms who report the variables, and for use by government and other institutions.

2.1. THE VARIABLE TO USE

The most common variables used to define SMEs globally are number of employees, assets and turnover. Some countries caveat these variables by enterprise type as well, defining separate boundaries for different sectors. Additionally, some countries also add requirements of independence and formal registration. The International Finance Corporation (IFC) collects data on the definitions and the composition of micro, small and medium enterprises in the Micro, Small and Medium Enterprise (MSME) Country Indicators dataset. This data, which was last collected in 2014, includes 155 economies (MSME-CI data, 2014).

The most commonly used variable for defining MSMEs in this dataset is the number of employees. 92 percent of the definitions in the dataset used this variable. Second and third most commonly used variables are turnover (49 percent) and assets (36 percent) respectively (Gonzales, Hommes, & Mirmulstein, 2014). Pakistan's definition, which uses employees and turnover, is fairly common, as shown in Figure 1 below.

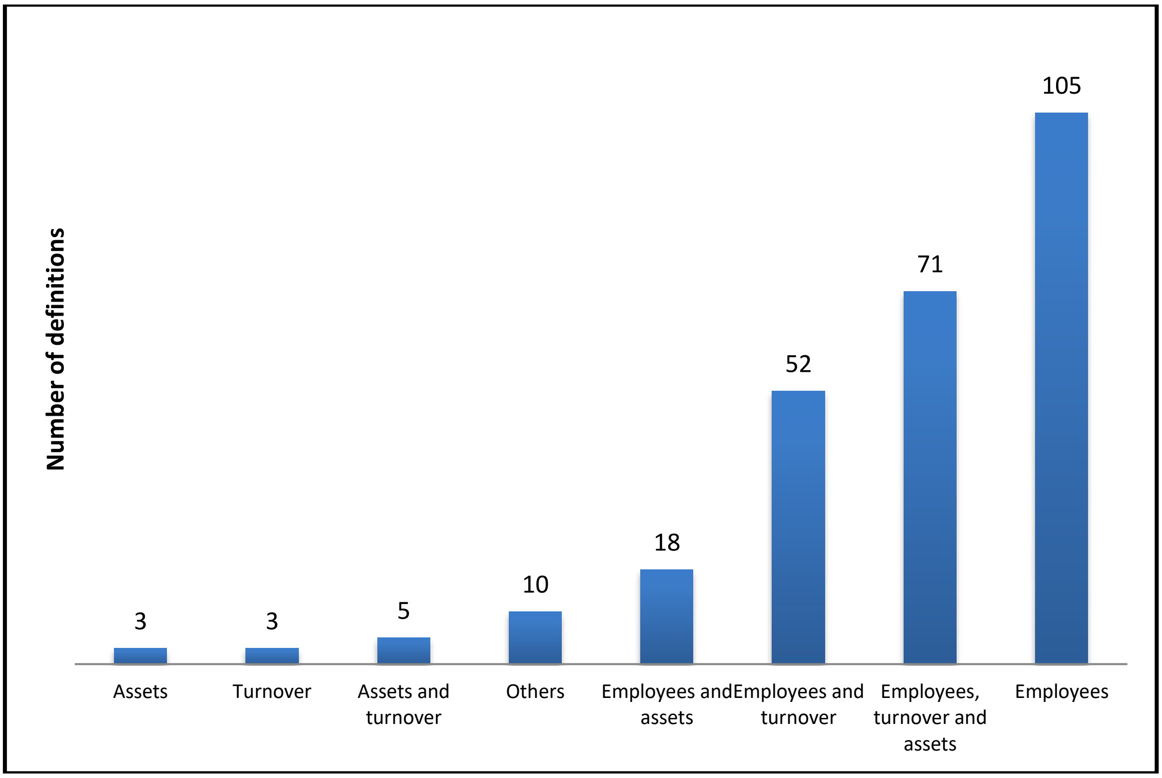

Figure 1: Common variables used in defining MSMEs

Source: MSME-CI dataset, 2014

Employment is the simplest variable to collect and observe. However, when using number of employees to define SMEs, there are typically different thresholds defined for different sectors, in recognition of the differences in employment intensity by sector. In Pakistan, for example, the State Bank of Pakistan (SBP) defines SMEs as those that employ fewer than 250 employees in the manufacturing and services sector, but that employ fewer than 100 firms in the trading sector. Other countries also define services, agriculture, mining, transport and/or construction separately. Yet, adding more categories to fine-tune the suitability by sector reduces the convenience and simplicity of the definition – both important determinants of how successful the definition will be.

Furthermore, in Pakistan in particular, employment numbers are difficult to ascertain. Most firms hire contractual labor, at least in part, and also exhibit seasonal variations in the number of people employed. It would require additional clarification on whether these employees are to be included in the definition, which impacts the ease of use of the definition. The European Union (EU) definition resolves this by expressing basic headcount as full-time equivalents i.e. a person who works at an enterprise full-time for a full year is counted at one unit, and others that work seasonally or part-time are considered as proportional fractions of this (European Commission, 2016a). However, this model adds further steps of data collection and calculation that would make it less practical to implement in Pakistan, where data reporting, collection and capacity are more significant administrative impediments.

More critically though, defining SMEs by number of employees creates undesirable incentives. If, as per the intended purpose of an SME definition, firms that employ fewer people are classified as small and offered greater support, it would act as a disincentive for labor intensive firms and for firms looking to increase employment. At a time when Pakistan is experiencing a demographic bulge, this is certainly not a signal that the SME policy should give.

Fixed assets are also commonly used, mostly in conjunction with another variable, and typically with separate thresholds for different sectors (e.g. services, manufacturing, construction). As with employment, this reduces the simplicity and ease with which the definition can be used. It requires a valuation of the firms' assets by an independent authority or a Chartered Accountant. Using fixed assets would add an additional layer of administration and private-public interface at a time when Pakistani firms are already encumbered with excessive red tape. In addition, it suffers from similar disincentive issues as the employment-based definition. New technology is valued more than older technology, and certain sectors require a greater value of fixed assets, therefore tilting the playing field towards older firms and less capital-intensive sectors. There is also scope for manipulating the fixed asset certification in order to qualify for SME specific incentives, such as in public procurement. For these reasons, some countries have moved away from fixed assets towards turnover. India is amongst them, defining SMEs by turnover instead of fixed assets from March 2018.

Turnover is typically used in conjunction with other variables, but is increasingly being used on its own too. It has several advantages. Firstly, it is equally appropriate for all sectors, and does not require further caveats by sector. Secondly, it is relatively simple, and uses data that is already collected and reported for tax and credit purposes. Thirdly, it is suitable for multiple uses e.g. credit quotas, tax exemptions and public procurement. Finally, it is easy to benchmark with Consumer Price Index (CPI) or Gross National Income (GNI) per capita, allowing for the thresholds to be flexible and remain relevant as the economy changes. On the downside however, similar to employment, turnover is typically underreported. This issue is shared with all variables though, so is not useful as a filter. In addition, underreporting has the potential to improve over time. Any gains from formalization and reporting, and financial inclusion through the use of banking for business transactions, will have positive spillovers for taxation, credit worthiness and for SME definition as well. A further weakness of turnover is that small firms that buy large quantities of goods and services would be classified as large. This is particularly true of trading firms. Value-added is the ideal variable to use to circumvent this, but difficulties in calculation make its usage impractical.

Additional considerations with regards to the variables to use are the requirement of formality, and the requirement of independence. The EU definition, for example, recognizes that a small firm may have access to significant extra resources if it is owned by, linked to, or partnered with a large enterprise. To be categorized as an SME, firms in the EU must establish that they are autonomous i.e. either completely independent or have one of more minority partnerships, each with a share of under 25 percent. This applies both to shares that other companies hold in the enterprise, and that the enterprise holds in other companies. There are exceptions to this for public investment companies, venture capital companies and business angels, universities and non-profit-making research centers, institutional investors including regional development funds, and autonomous small local authorities. In case of linked enterprises, the data of all linked enterprises is used cumulatively to calculate the total headcount. (European Commission, 2016a).

With regard to formality, Gibson and Vaart (2008) find that formal enterprises are more likely to grow, and suggest the inclusion of formality as a criterion for definition as SME. Including informal enterprises has the advantage of supporting firms before they are ready to formalize. This might be important in Pakistan's context, as firms choose to remain below the radar of government officials till their business model is successful, to avoid red-tape and taxation. However, the disadvantage of including such enterprises is that most of these will remain small and may never register. It is difficult to justify spending taxpayer's money on supporting such firms, particularly when it adds to the disincentive to register. Supporting legally registered firms helps identify high growth firms, and also creates incentives for firms to formalize.

2.2. THE THRESHOLD TO SET

A useful SME definition is one that helps serve the purposes for which the definition will be used for. Principally, this purpose is to identify firms for interventions targeted at offsetting the disadvantages and market failures that accrue specifically due to their size. These interventions can include regulatory exemptions, differential taxation treatment and direct interventions such as subsidized BDS, and preferential access to public procurement and finance.

Secondary uses are that an SME definition is used to collect and organize data to understand the role of SMEs, to evaluate the impact of SME policies and to provide information to firms. In addition, a nationally accepted SME definition can help coordinate efforts across multiple agencies such as SMEDA, SBP, Punjab Small Industries Corporation (PSIC), FBR and SECP by ensuring that the term "SME" or "small" refers to a common and easily understood metric.

This section starts with an analysis of the size distribution of firms in Pakistan in order to understand what size of firm is "small" by Pakistani standards. This is followed by a discussion of the size at which size-related disadvantages taper off based on stakeholder perceptions. A comparison is then made with the thresholds set by other countries at similar levels of development. Finally, the relevant demarcations within SME definition are discussed in the context of the differential impact of different types of SMEs on the economy.

Size Distribution of Firms

The last economic census was published in 2005, with data collected from 3.25 million establishments across the country between 2001 and 2003 (Pakistan Bureau of Statistics, 2005a). Table 1 shows the distribution of firms in different industries by the number of employees in each industrial division. The large majority of firms employed fewer than five people. Mining and quarrying is a notable exception, employing larger numbers per firm on average. However, even for mining and quarrying, 97.5 percent of firms employed fewer than 50 people in 2001-2003. For the remaining industries, this figure is over 99 percent. To put this in context, the employment threshold of the State Bank definition for SMEs is 250 employees, and for small firms is 50 employees. Clearly a definition like this will include almost every firm in Pakistan, and therefore will not be useful.

Table 1: Percentage of establishments in each employment category, by major industry division

Major industry division	**Employment size, in number of employees**				
	1-5	6-10	11-50	50-250	251 +
Agriculture, Forestry, Hunting and Fishing	94.39	5.23	0.37	0.02	-
Mining and Quarrying	41.65	36.04	19.78	2.24	0.28
Manufacturing	86.74	10.94	2.13	0.17	0.03
Electricity, Gas and Water	89.52	4.03	5.65	0.81	-
Construction	87.73	10.14	2.06	0.07	-
Wholesale and Retail, Trade and Restaurants and Hotels	98.02	1.86	0.12	0.00	0.00
Transport, Storage and Communication	94.91	4.40	0.64	0.04	0.01
Financing, Insurance, Real-Estate and Business Services	92.89	5.93	1.11	0.06	0.01
Community, Social and Personal Services	92.96	5.34	1.65	0.05	0.00

Source: Pakistan Bureau of Statistics, 2005a

The Census of Manufacturing Industries (CMI) 2005 also shows that the distribution is heavily tilted towards very small firms, though instead of 99.8 percent of manufacturing firms employing fewer than 50 people that the Economic Census reports, in the CMI 65 percent of all manufacturing firms employ fewer than 50 people (Figure 2). 84.4 percent of firms employ fewer than 250 people.

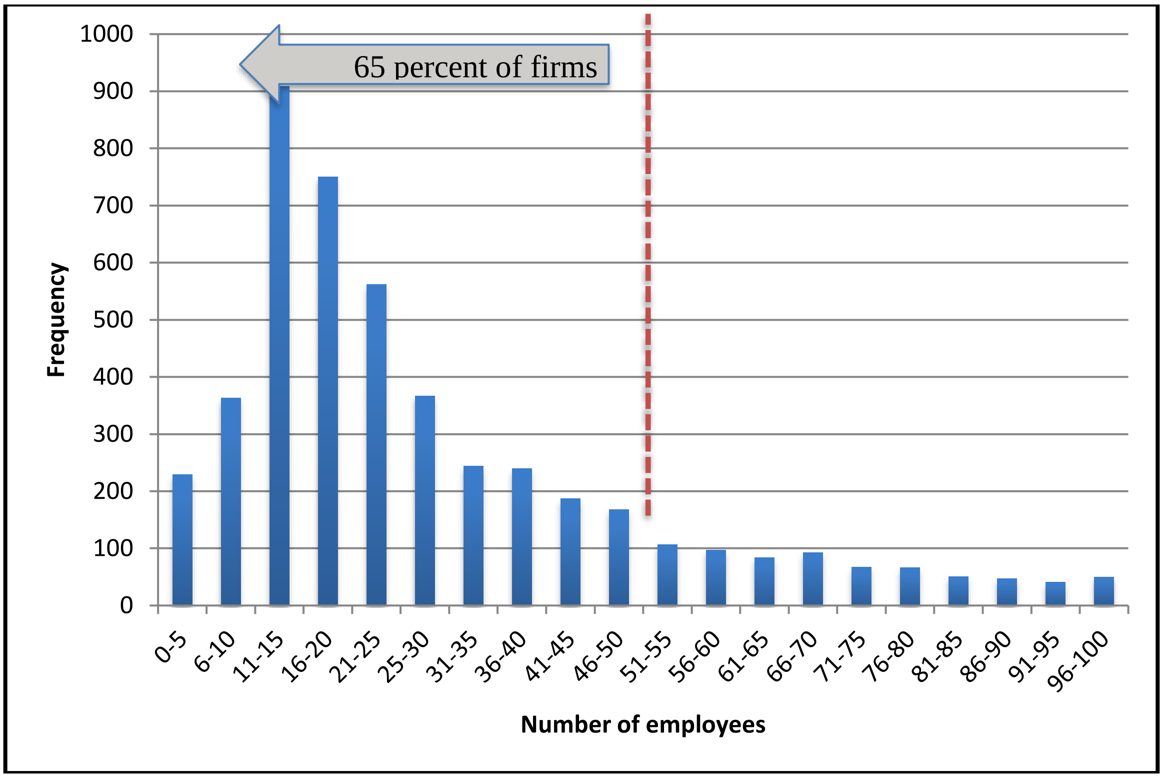

Figure 2: Distribution of firms by employment

Source: Pakistan Bureau of Statistics, 2005b

Note: the distribution is cut off at 100 employees for ease of illustration. The chart covers 75 percent of all firms surveyed in the CMI. The remaining 25 percent of firms comprise a long thin tail in the distribution. Approximately 7 percent of the firms in the CMI employ over 1,000 people.

Figure 3 charts the size distribution by of firms by annual sales revenue, showing that nearly half the firms reported a sales turnover under PKR 1 million, and 75 percent of firms report a turnover under PKR 3 million.

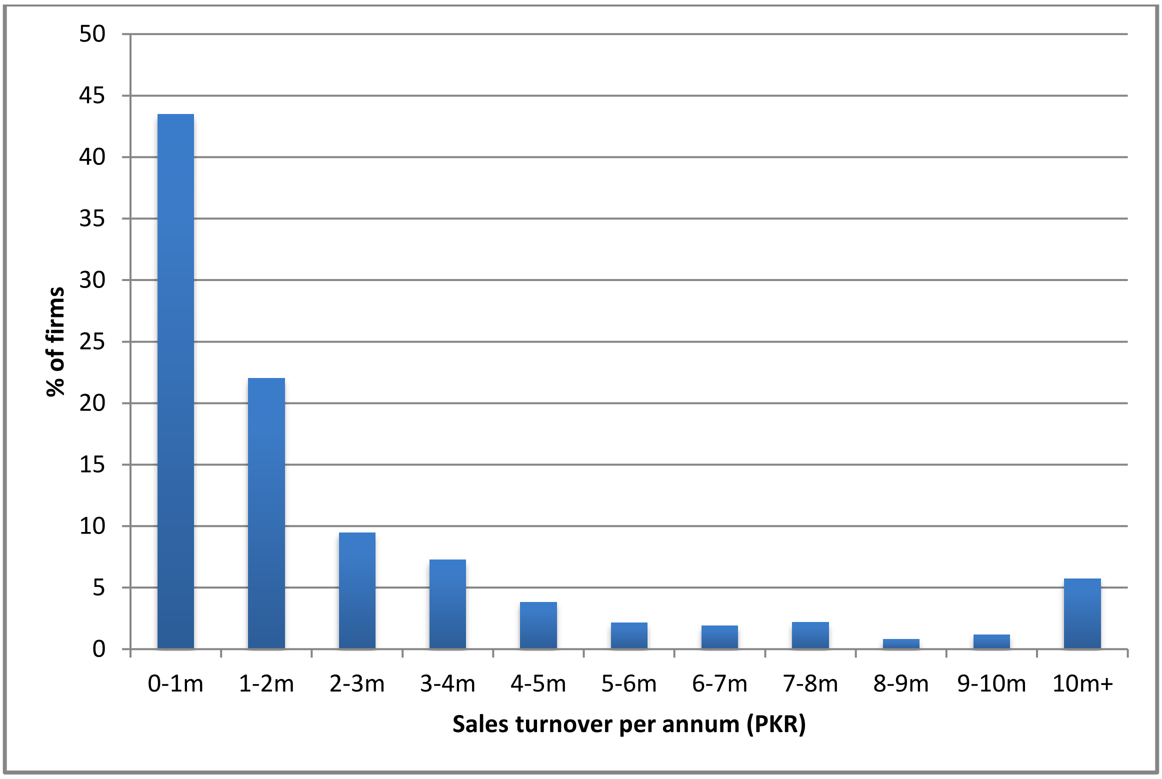

Figure 3: Distribution of firms by annual sales revenue, Economic Census

Source: Pakistan Bureau of Statistics, 2005a

Table 2 breaks this down by sector. Again, the notable exception is mining and quarrying, where firms are larger. Over 99 percent of firms in all sectors apart from mining and quarrying had sales revenue of under PKR 10 million in 2003. To put this in context, the State Bank sales definition currently defines SMEs as those that have sales turnover less than PKR 800 million, and small firms as those that have sales turnover less than PKR 150 million. Given that 99 percent of firms are a fraction of this number, the definition appears to cover almost every, if not every, firm.

Table 2: Percentage of establishments in each sales revenue category, by major industry division

Major Industry division	**Sales Revenue**						
	Below 500,000	500,000 to 1 million	1-2 million	2-5 million	5-10 million	10-250 million	250 million +
Agriculture, Forestry, Hunting, and Fishing	85.70	8.87	3.71	1.27	0.34	0.11	0.00
Mining and Quarrying	30.01	16.41	25.39	18.65	3.09	6.17	0.28
Manufacturing	87.87	6.15	3.11	1.77	0.51	0.55	0.03
Electricity, Gas, and Water	91.13	0.81	2.42	0.81	0.81	3.23	0.81
Construction	84.89	6.81	4.68	1.84	0.78	0.85	0.14
Wholesale and Retail Trade & Restaurants and Hotels	77.18	13.29	5.57	2.68	0.81	0.46	0.00
Transport, Storage and	90.5	5.59	1.9	1.3	0.4	0.2	0.0

Table 2: Percentage of establishments in each sales revenue category, by major industry division

Communication	3		5	0	0	2	1
Financing, Insurance, Real-estate and Business Services	84.95	8.31	2.98	2.17	0.80	0.75	0.04
Community, Social and Personal Services	96.45	2.45	0.73	0.26	0.06	0.04	0.00

Source: Pakistan Bureau of Statistics, 2005a

While it is not possible to put a quantitative estimate on how the distribution might have changed in the last fifteen years, the distribution can at least be adjusted in money terms to the state of the economy and current prices. We do this by weighting the 2003 figures with the ratio of GNI per capita today vs. 2003.[5] The sales revenue that covered 99 percent of firms was PKR 10 million in 2003, which translates into PKR 18.6 million when weighted with GNI PPP per capita.[6] There still remains an extraordinary distance between the PKR 800 million that the SBP suggests that defines SMEs. While at least some of this distance can conceivably be explained by under-reporting, the 43-fold difference indicates that the definition is likely to be quite uninformative in that it covers almost every firm in the country.

The CMI 2005 provides an additional source of information for manufacturing firms. As indicated in Table 3 approximately 94 percent of manufacturing firms had sales revenue under PKR 150 million. While the CMI shows a larger average size of firm than the Economic Census, it still suggests that the threshold of PKR 800 million will cover almost all firms, and therefore not offer SMEs any targeted affirmative action.

Table 3: Sales revenue distribution

Range	Percentage of firms
0 < Sales < 150 million	93.72
150 million < Sales < 800 million	4.97
Sales > 800 million	1.31

Source: Pakistan Bureau of Statistics, 2005a

Stakeholder Views

Another data point comes from the nearly two hundred SMEs that were consulted during the stakeholder focus group discussions held specifically for this SME policy formulation exercise. The firms were asked how they would define a small firm in the context of their industry group, and the size at which the disadvantages that arise due to size begin to taper off. A consensus building exercise was undertaken with every group till a common understanding was established. Details of each focus group discussion are available in the Report on Filed Work (Deliverable 2). In this section we summarize the main results.

Two major findings emerged from the discussions. Firstly, most participants agreed on the need to bifurcate the SME definition into micro/ cottage, small and medium, rather than in one large SME category, as each sub-category faces different kinds of constraints. Secondly, while there was some variation in the suggested thresholds, they converged generally around sales of up to PKR 50 million for Small and up to PKR 200 million for Medium. For employment, the threshold was 0-5 employees for Micro, 5-25 for

[5] GNI per capita is used to reflect the state of the economy's development, as per Gibson and Vaart (2008)

[6] GNI per capita in Purchasing Power Parity (PPP) was USD 3,130 in 2013, and USD 5,830 in 2017.

Small, and up to 100 for Medium. These figures are consistent with the findings from the analysis of distributions described above.

Comparison with Other Countries

A final data point that can be used to arrive at an SME definition is to compare the definitions used in other countries. For this, we use the IFC MSME Country Indicators dataset 2014 that provides data on SME definitions for 155 economies (MSME-CI data, 2014). The Inception Report (Deliverable 2) provides a comprehensive comparison of Pakistan's distribution and definition of SMEs with global and regional averages, and averages for lower-middle income countries. This section summarizes the main findings.

In terms of employment, the South Asian average definition for SMEs is 139 employees and the average for lower middle-income countries of 132 employees, both nearly half Pakistan's State Bank definition of 250 employees. Similarly, while Pakistan defines small enterprises as those employing fewer than 50 people, the South Asian average is 34 people.

For turnover as well, in 2011 the high-income countries' thresholds ranged from USD 50 million to USD 70 million, with an average of USD 59.4 million. This constituted 35 out of 267 definitions. The next most common range was USD 1 million to 5 million, used in 31 definitions, and below USD 1 million, used in 30 definitions. These lower ranges correspond to lower income countries. The average for lower-middle income countries was USD 6.8 million (Gonzales et al., 2014).

Again, Pakistan's definition of PKR 800 million appears to be higher than the average for its income group. At 2011 exchange rate, the threshold of USD 5 million works out to be PKR 450 million, and the average for lower middle-income countries of USD 6.8 million works out to be PKR 612 million.[7] Both are considerably lower than the current SBP definition of PKR 800 million. In addition, Pakistan's size distribution of SMEs is more heavily skewed towards micro firms, even compared to similar income economies and the region (MSME-CI data, 2014). This suggests that the threshold be *lower* than comparison countries rather than higher.

Since India has shifted to a turnover-based definition earlier this year, it is useful to benchmark with that too.

Table 4: India's thresholds for defining SMEs

Annual Sales Turnover			
	In Indian Rupees (INR)	In PKR, at exchange rates of 31/12/18[8]	In PKR, weighted with GNI per capita at Purchasing Power Parity (PPP)[9]
Micro	50,000,000	100,500,000	82,990,793
Small	750,000,000	1,507,500,000	1,244,861,898

[7] The exchange rate at 31/12/2011 was PKR 89.96/1USD. Available at https://www.exchange-rates.org/Rate/USD/PKR/12-31-2011
[8] https://www.xe.com/
[9] India GNI per capita in 2017 is 1.21 times higher than Pakistan's https://data.worldbank.org/indicator/NY.GNP.PCAP.PP.CD

Table 4: India's thresholds for defining SMEs			
Medium	2,500,000,000	5,025,000,000	4,149,539,660

Source: Author's calculations and Bhardwaj, 2018

Demarcations within the SME Definition

Conversations with private sector stakeholders and banks, and international practice suggest that the SME definition be divided further in order to better target the relevant firms. Demarcating these boundaries requires a better understanding of why SMEs need this support. Targeted support for SMEs must be clearly justified in economic reasoning and evidence to ensure that intervention is not wasteful or distortionary. There are two arguments typically put forward for affirmative action in support of SMEs that can define which firms to support: 1) That there are market, structural and state/institution failures, and coordination issues that accrue due to size that need correction, and 2) SMEs are thought to contribute more heavily than large firms to employment and growth.

The first of these arguments finds considerable support in secondary literature, and in our own data analysis and fieldwork (described in detail in Deliverable 1: Inception Report and Deliverable 2: Report on Field Work). For example, both banks and small firms spoke of asymmetric information leading to an undersupply of credit to SMEs. Similarly, small firms are impacted more by regulatory problems and infrastructure deficiencies. Correcting such failures provides a solid basis for both horizontal reforms (which impact SMEs disproportionately) and for SME-specific affirmative action such as exemptions from certain regulations, or credit bureaus that allow firms to signal credit-worthiness to banks. The natural demarcation of which firms to support using this argument are the ones that suffer from these market, institutional and coordination failures.

The second of the arguments finds considerably less support, both in secondary literature and in our own fieldwork. While small firms may lead to greater job creation, they are also subject to greater job destruction through a greater propensity of firms to exit; they also have, on average, lower productivity, pay lower wages and invest less in training (Berlin Economics, 2014). More nuanced studies find that, controlling for a firm's age, there is either no impact (e.g. Haltiwanger, Jarmin & Miranda, 2012; Page & Soderbom, 2012) or that large firms create more jobs (Biggs, 2002; Brummand & Connolly, 2018). Studies also show that higher value jobs are created in larger firms, and that age might be the more relevant factor rather than size when it comes to job creation. In any case, job creation is a function of several factors other than size (Ayyagari, Demirguc-Kunt, & Maksimovic, 2011). Therefore, one cannot justify SME interventions on the basis of greater employment spillovers, and a policy that attempts to keep companies small and medium is not efficient.

A corollary to the arguments above is that SMEs are to be supported in dealing with market/ state failures, not because they themselves contribute disproportionately to the economy, but because they have the potential to grow into medium and large sized firms. Therefore, the relevant category of SMEs to support is those that have greater potential for growth. Yet the large majority of firms do not grow, and do not have an ambition to grow (Lerner & Schoar, 2010). For Pakistan this is demonstrated in Figure 4. Over 90 percent of even the oldest firms in the sample employed fewer than five people even two decades after they were established. However, while the percentage of firms that employ over a hundred people is just 0.15 percent amongst firms that were at least 25 years old, this is fifteen-fold higher than the 0.01 percent of such firms that were five years old. The challenge is to identify this small number of firms with a high growth potential and support them specifically to achieve their growth ambition.

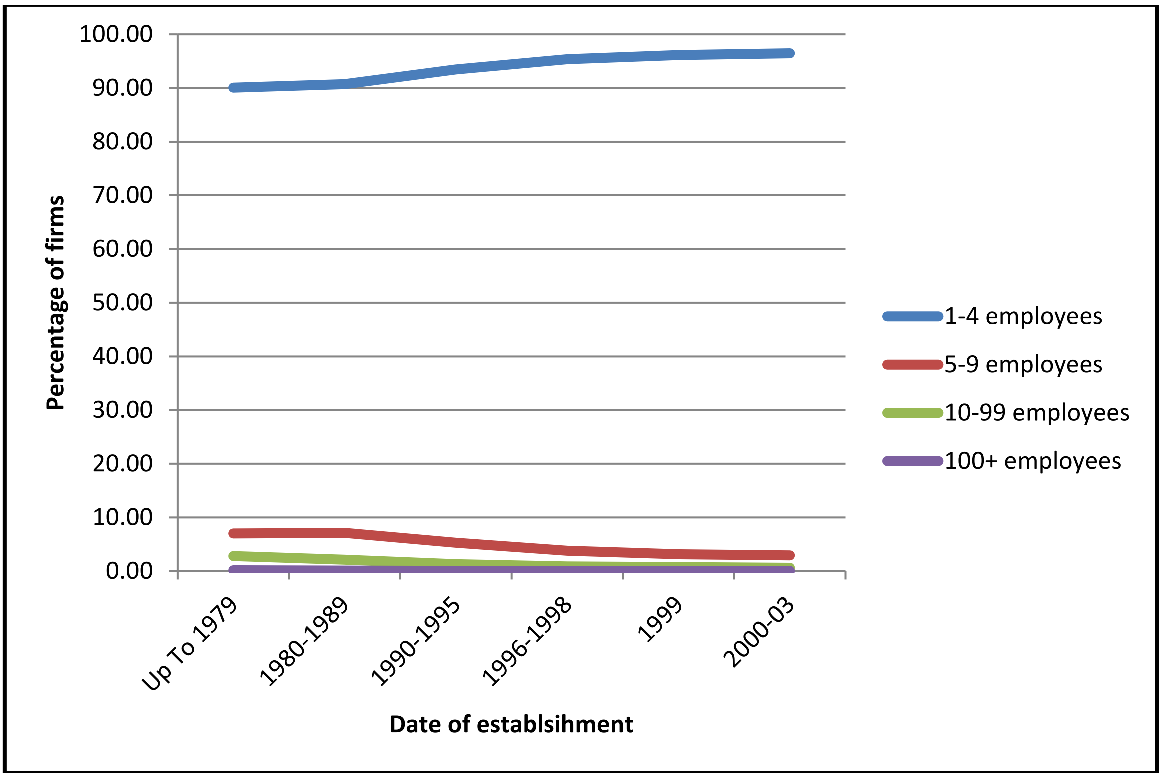

Figure 4: Employment by date of establishment of firms

Source: Pakistan Bureau of Statistics, 2005a

Gibson and Vaart (2008) define several common characteristics of firms that lie in that category e.g. they are formally registered, willing to provide formal skills training, able to invest in capital with payback longer than 12 months. They also have important differences with large firms e.g. they are less likely to have personal high-level contacts with government and the financial sector, more likely to be managed by their owners rather than professionals, less able and inclined to follow business plans, and more focused on short-term needs rather than long term market share. They argue that the variable that is best matched to these characteristics is turnover, not assets or employment. Moreover, contrary to what we have found, they find no major differences between small and medium firms, and suggest a single SME group. They propose a simple formula that links the size of the SME to the level of development in the economy, as measured by GNI per capita. The range is based on empirical evidence of SME growth trends in developing countries. This formula is:

"An SME is a formal enterprise with annual turnover, in U.S. dollar terms, of between 10 and 1000 times the mean per capita gross national income, at purchasing power parity, of the country in which it operates." (Gibson and Vaart, 2008)

Pakistan had a GNI per capita of USD 5,830 in 2017 (World Development Indicators, 2018). This translates to an SME definition sales turnover range of PKR 6.45 million to PKR 645 million at the exchange rate in 2017.[10]

[10] 1 USD = 110.63 on 29/12/2017. Source: https://www.exchange-rates.org/Rate/USD/PKR/12-29-2017

Note that the formula does not include informal, unregistered firms and also has a lower bound cut-off, based on empirical evidence that high growth firms are unlikely to start off smaller than this, and a firm larger than this would not be considered small.

2.3. THE DEFINITION

Based on the empirical evidence presented above, the following definition is proposed.

Table 5: SME definition

Category	Definition
New	Registered, independent enterprises, under 5 years old, with a sales turnover of up to PKR 50 million
Micro	All enterprises with a turnover below PKR 6.5 million, not elsewhere categorized
Small	Registered, independent enterprises, with a sales turnover above PKR 6.5 million and under PKR 100 million
Medium	Registered, independent enterprises, with a sales turnover between PKR 100 million and PKR 650 million

Several features of this definition are important to note:

1. There is an additional category of small start-ups defined, the notable feature of which is the age. Empirical evidence shows that the large majority of small firms remain small and have no ambition to grow. If a firm has not grown after five years, it is not likely to be a high-growth potential firm. This category of firms should receive substantial affirmative action, as they face the highest disadvantages due to size, and yet also have the highest potential to grow. The age criterion provides a natural in-built sunset clause – after five years a firm has either graduated out of that category, or has demonstrated that it is likely to remain small or die out. Either way, the firm no longer qualifies for continued support
2. There is a lower bound cut-off of PKR 6.5 million, and being formally registered, in the definition of SMEs. Both these are identifiers for those firms that are likely to make greater long-term contributions to the economy.
3. There is a requirement for the firm to be independent i.e. have under 25 percent share in other companies, and have under 25 percent of its shares owned by another company. As in the EU, exceptions can be made for public investment companies, venture capital companies, business angels etc.
4. Micro firms are identified as those firms that are unregistered and/or have a sales turnover under PKR 6.5 million after 5 years of their inception.
5. It is recommended that these micro firms are not offered the SME tax concessions, public procurement, credit targets etc. These firms are filtered out to promote efficient targeting within a constrained fiscal space, in light of the findings that subsistence entrepreneurs create minimum employment and are unlikely to grow. Cross-cutting interventions such as regulatory and business environment improvements apply equally to these firms.
6. SMEs can be defined broadly by combining the definition for small and medium above. However, we recommend that wherever possible, the distinction in affirmative

action is made at the disaggregated level, for reasons noted in point 1 above

7. As in the EU, it is further proposed that an enterprise falls out of the category if it exceeds the turnover for two consecutive years (European Commission, 2016a).
8. The thresholds should be revised in line with GNI per capita in the next SME Policy.

3. MACRO POLICIES AND SMES

A macroeconomic policy environment that is stable and business friendly is imperative for growth of SMEs, which represent the vast majority of private sector economic activity in Pakistan. This would require policies that result in a low inflation rate, a market determined competitive exchange rate, a broad based non-distortionary and business friendly tax structure and trade policies that foster efficiency and improve competitiveness of the private sector. This section focuses on trade, monetary/ interest rates and taxation policy and puts forward a set of recommendations that are likely to create a conducive macro environment for SMEs to grow.

3.1. TRADE POLICY

The export performance of Pakistan has been consistently dismal for the last five years, resulting in a widening trade deficit that reached USD 38 billion in 2017-18. Although the fall in exports since 2014 is a consequence of a steady and endemic decline in manufacturing competitiveness, the macro and trade policy environment in the country has not been conducive towards exports either.

An appreciated exchange rate and escalation of tariffs on imported raw materials and intermediate goods have contributed to the fall in exports. Exporting firms have also faced serious liquidity crisis due to non-payment of sales tax refunds and duty drawbacks of approximately PKR 300 billion. With the recent increase in interest rates, the cost of capital to firms has risen, which could potentially dampen investment and exports. Moreover, poorly negotiated preferential trading agreements, such as the FTA with China in 2007, have not led to any significant increase in exports. Instead there is evidence which suggests that the FTA with China has contributed to the de-industrialization in the country with small enterprises facing the brunt of cheap Chinese imports.[11] Finally ad-hoc changes in trade/tariff policy through a plethora of Statutory Regulatory Orders (SROs) creates uncertainty and increases the cost of trade, hurting exports and future investment in the economy.

As mentioned earlier, the SME sector comprises of almost 99 percent of economic activity in Pakistan. Most of the manufacturing and agriculture-based industry in the country is dominated by SMEs which includes the major export sectors such as textiles and clothing, rice, light engineering, leather, sports goods and surgical items. If not exporting directly, SMEs are part of the value chain of largest manufacturers and exporters, including MNCs, through sub-contracting or vending arrangements. Trade and macroeconomic policies which are conducive to exports would consequently have an impact on the SME sector – on both exporting firms and their sub-contractors. The following set of recommendations are derived from the literature on SMEs and exports in Pakistan and the recent report by the EAC's committee on Exports and SMEs. The recommendations take into account international best practices and are based on the

[11] Anecdotal evidence shows that local manufacturing of ceramics, electric machinery and equipment, chipboard, plywood, bicycles, etc., and a number of small-scale industries have also been impacted by low cost imports from China. (Kamal & Malik, 2017).

extensive field survey (focus group discussions) conducted for this particular report. While these areas do not come directly under SME Policy, they are important advocacy recommendations for SMEDA to take-up with the relevant departments under its envisaged role of coordinator and voice of SMEs.

Elimination of SROs and Introduction of a Strategic Trade Policy

The current SRO based trade regime creates arbitrariness, opacity and uncertainty in the economy and ends up benefiting traders or larger inefficient firms seeking protection. As a principle, the trade and tariff policy should be made in consonance with the Investment, Industrial and SME Policies and not determined by fiscal or revenue considerations of FBR. It is recommended that all the existing SROs should be reviewed, revised and consolidated into a single SRO. The consolidated SRO should be reviewed and approved by the Fiscal Policy Board before being taken to Parliament for final approval. In case any new sector/industry specific SRO needs to be issued as an amendment to the existing consolidated SRO it should be for a limited and specified duration and would have to go through the same process of approval. In addition, there needs to be a strong SME advocacy voice in the Commerce Ministry, which represents the interests of the sector in trade policy formulation.

The Strategic Trade Policy Framework should be focused on galvanizing the SMEs in the country in order to get the widest possible impact on the economy. The following are some basic recommendations, which would help increase profitability and enhance the export potential of SMEs in the short run.

Reduction of Tariffs on Inputs

High tariffs on imported inputs and the excessive protection of local raw material/intermediate goods producers substantially increase the cost of production of firms in Pakistan particularly SMEs. These input tariffs should be reduced in order to increase the profitability of SMEs. SMEs that are manufacturers and exporters should be completely exempt from any input tariffs.

More specifically, import tariffs on all raw materials, intermediate goods and machinery, which were increased from 0 to 3-5 percent in the last five years, should be at zero tariff. Import tariffs on all the raw materials, intermediate goods and machinery at higher than 3 percent slab (11 percent, 16 percent or 20 percent slab) should be brought down to zero - one slab down every two years.

Import tariffs on raw material and intermediate goods should also be eliminated for SMEs that are vendors to exporting firms. Therefore, the current DTRE scheme needs to be extended to both SME manufacturers and exporters and indirect exporters – vendor SMEs.

Currently industrial importers pay a lower tariff on imported raw materials and intermediate goods compared to commercial importers. This distinction in tariffs discriminates against SMEs who have to rely on raw materials and intermediate goods imported by commercial importers. It is recommended that industrial and commercial importers should face the same tariff regime. Furthermore, the Competition Commission should ensure fair pricing by commercial importers and penalize formulation of cartels.

As detailed ahead, two schemes, simplified DTRE and central bonded warehouse facility, are recommended to ease procurement of imported raw material and intermediate goods for manufacturer exporters, in particular those that are classified as SMEs.

The procedural requirements of the current DTRE scheme are fairly complex and need to be simplified. The following is a recommendation given by the EAC sub-committee on Exports for simplification of the DTRE procedure and for the establishment of central bonded warehouse facilities.

- ***DTRE Scheme*** *– 'There is a need to simplify the DTRE Scheme and establish an on-line system for 'permission to import' inputs as per notified list of ratios of export value (by product) and annual allocations (based on previous years' exports) for eligible exporters. For this purpose, it is proposed that the ratios (in terms of value of exports) of permitted imports of intermediate goods and raw materials be notified by the Government by export category, say at the eight-digit HS classification level. At the same time a list of intermediate goods and raw materials that are eligible to be imported by an exporter in that export category should be notified. Based on the notified ratios and previous years' exports, each exporter would be allocated a maximum amount that she/he can be import in the next year. A system should be set up which allows an exporter to get clearance online for import under DTRE of intermediate goods and raw materials on the notified list, up to his/her remaining allocation. Operation and monitoring of compliance of the online system should be the responsibility of SBP/ Commercial banks and not the customs department'.* (Pakistan Economic Advisory Council, 2018).
- ***Central bonded raw materials and intermediate goods warehouse facility*** *– 'Central Bonded Warehouses can be established by the private sector for raw materials / intermediate goods for purchases by SME exporters as per notified list of ratios and annual allocations. The warehouses would be particularly important for SMEs as the DTRE scheme may not be suitable for them because of smaller quantities of imports involved. It would be similar to the DTRE scheme in terms of determining the import allocation and the list of eligible intermediate goods and raw materials for individual exporters, but in this case, they would be able to purchase their requirements from the warehouse instead of importing the goods directly. Bonded warehouses are working successfully in Bangladesh, which can be used as a model'.* (Pakistan Economic Advisory Council, 2018).

Disbursement of Pending Sales Tax Refunds and Duty Drawbacks

Exporters have been facing severe liquidity crisis because of delayed payment of the sales tax refunds and duty drawbacks. This shortfall is normally met by bank financing which increases the financial cost and affects competitiveness of exports. For SMEs this liquidity problem is even more binding as they do not have easy access to bank financing. It is therefore recommended that pending payments should be disbursed immediately with priority given to SMEs. In the future such payments should be made immediately by the State Bank as soon as export payments are received. (Pakistan

Economic Advisory Council, 2018). Currently the duty draw back system works in parallel with the DTRE. It is recommended that duty draw backs be phased out and a reformed DTRE system (as described above) be put in place instead. (Pakistan Economic Advisory Council, 2018*).*

Reform Customs Procedures to Facilitate Trade

In order to improve trade competitiveness, it is imperative for Pakistan to reform its customs procedures and improve its border management. The country ranks 142 out 190 economies for "trading across border" and it takes 75 hours for exports to fulfil border compliance compared to the South Asian average of 63 hours and an Organization for Economic Co-operation and Development (OECD) average of just 12.5 hours (World Bank, 2019). In the focus group discussions, exporting firms (among others) highlighted delays in customs clearance and the arbitrariness of officials in determining duties on goods, as a major cost to trade. To address this, issue a National Single Window (NSW) system is being developed to connect all trade-related stakeholders, agencies and institutions within the country through a single data information exchange platform. The government should expedite the implementation of this initiative and aim to have it up and running in 2019 (Pakistan Economic Advisory Council, 2018*).*

In addition, a Trade Facilitation Unit (TFU) should be established in FBR with the aim to first map the steps, documents and procedures required to import and export goods in Pakistan. It should than develop a plan to simplify these procedures by reducing the number of steps and required documents. To implement this, the government should setup a model business-friendly trade facilitating custom clearance unit in one location, such as Sialkot, as a pilot. This could be subsequently scaled up and replicated across the entire country in the next two years at other dry ports (i.e. Faisalabad / Lahore / etc.) and finally implemented in Karachi. (Pakistan Economic Advisory Council, 2018*).*

Preferential Trade Agreements

Pakistan and China signed a free trade agreement in 2006. Since then the bilateral trade between the two countries has increased from USD 2.2 billion in 2005-06 to USD 15.6 billion in 2017-18. However, in this period the growth in imports from China increased from USD 1.8 billion to USD 13.9 billion, while Pakistan's exports to China went up from USD 0.4 billion to just USD 1.7 billion, resulting in an ever-widening bilateral trade deficit (Kamal and Malik, 2017). Pakistan's exports to China are dominated by basic commodities such as rice and cotton (75 percent of total exports to China in 2016). On the other hand, Pakistan imports mainly electronic equipment, machinery and iron and steel from China (53 percent of total imports from China in 2016). Numerous studies have shown that Pakistan has the potential of exporting much more to China than current levels if it were to negotiate lower tariffs on its exports (Irshad, Xin, Hui, & Arshad, 2018).

It is recommended that in the ongoing renegotiation of the FTA with China, Pakistan should seek the same level of tariff concessions on its exports as afforded to other countries on their products e.g., Association of Southeast Asian Nations (ASEAN) countries have negotiated lower tariffs then those applied to Pakistan's exports.

The negotiation should be evidence based i.e. taken on the basis of existing trade patterns and potential for specific products (at eight-digit Harmonized System (HI) code level), and following consultations with the private sector, including representation from SMEs. In selecting product lines for inclusion in preferential tariffs, priority must be given to industries where Pakistan has existing production/export capacity and for which there is a large and growing world market, i.e. in addition to textile, it should include light engineering, electrical machinery, metal manufactures (e.g. auto / motorcycle / tractor parts, fans, motors, pumps, cutlery, etc.) and pharmaceuticals. Agricultural products such as rice and citrus, and value-added food products should also be given priority. In addition, it is important to identify and negotiate non-tariff barriers to export for the priority product categories.

Moving forward, the government needs to have a clear strategy on Preferential Trade Agreements (PTAs). Most of the PTAs Pakistan has signed have not accrued any substantial economic advantage and seem to be more politically motivated. It is therefore recommended that PTAs should only be signed when the extent of bilateral trade and economic links with a country are substantial and the agreement would significantly increase trade and improve market access for SMEs.

In terms of a broader strategy for trade, Pakistan should aim to increase trade with its neighboring countries. The trade potential between Pakistan and India is the highest in the region with gravity model estimates ranging from USD 18 billion to USD 36 billion per annum (Kathuria, 2018). The close proximity of the two countries, market size and similarity of language, history and culture are the reasons behind the high predicted bilateral trade. The current trade between the two countries is approximately USD 2 billion per annum. Normalization of trade would entail Pakistan extending Most Favored Nation (MFN) status to India and for India to give market access to Pakistan's exports. Given India's large and growing market size and similarity of tastes and preferences, there will be tremendous opportunity and potential for SMEs to export a range of products across the border. Also, given the proximity between the two countries, SMEs could procure imported intermediate goods and raw material at a lower cost from India improving profit margins. There is also significant potential of services trade between the two countries, particularly in the case of religious tourism. The opening of the Kartarpur border corridor is a step in the right direction. With cross border religious tourism picking up, demand for services such as tourism, hospitality and logistics, most of which will be SMEs, would go up substantially. It is recommended therefore that Pakistan's medium-term trade strategy should focus on increasing regional trade, in particular with our neighboring countries such as India.

3.2. TAXATION POLICY

According to the World Bank Ease of Doing Business Report 2019, Pakistan's rank in Paying Taxes is 173 out of 190 countries. The country has a complex and inefficient tax system, with 47 tax payments in a year and an extremely narrow tax base. The burden of direct taxes falls disproportionately on the manufacturing sector and the salaried class. While heavy reliance on regressive indirect taxation comes at the cost of majority of the population which is poor.

Figure 5 shows that while Pakistan's total tax and contribution rate (which includes all taxes) is high, it is still lower than the world average, and the rate in India and Sri Lanka. However, many of these countries offer concessionary tax rates to SMEs. For example, In Thailand, while the corporate tax rate is 20 percent, certain SMEs are subject to lower progressive rates (Deloitte, 2018a). Similarly, Malaysia's offers a corporate tax rate of 18 percent to for the first Malaysian Ringgit (MYR) 500,000 SMEs compared to the standard of 24 percent (Deloitte, 2018b). China offers 10 to 20 percent for small-scale enterprises (Deloitte, 2018c).

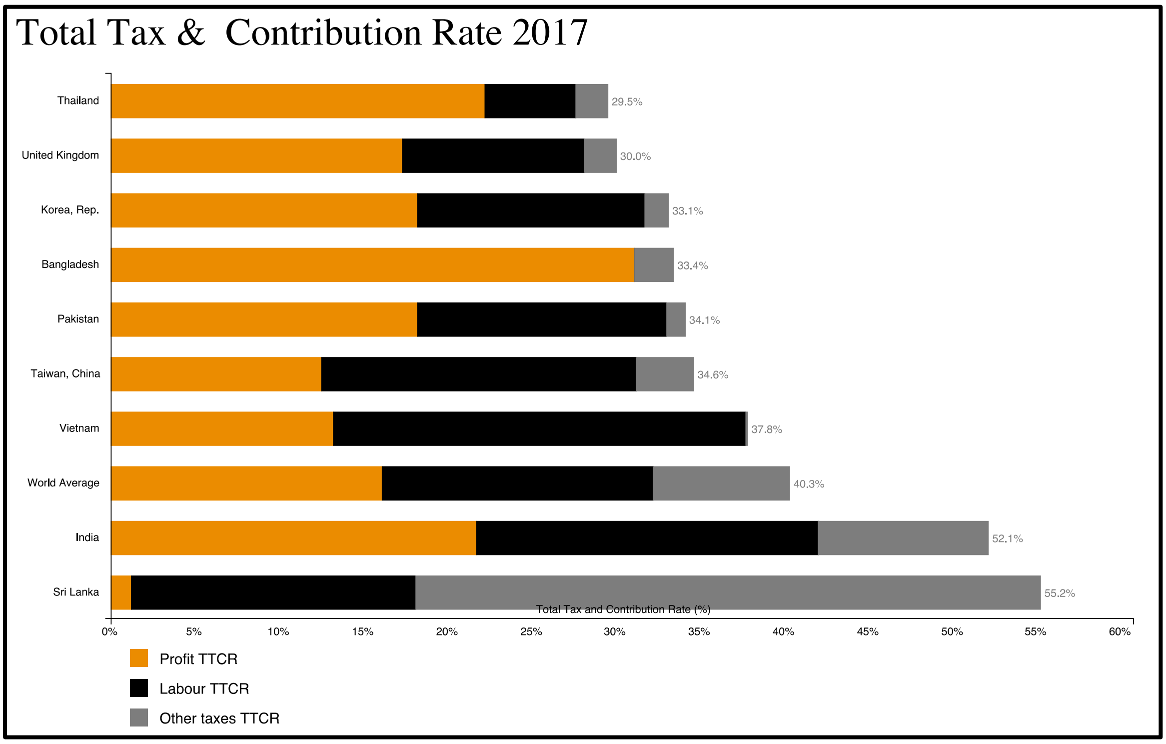

Figure 5: Benchmarking Pakistan's tax and contribution rates

Source: PwC Interactive Tax Data Explorer

Note: Some of the figures in the chart may be rounded.

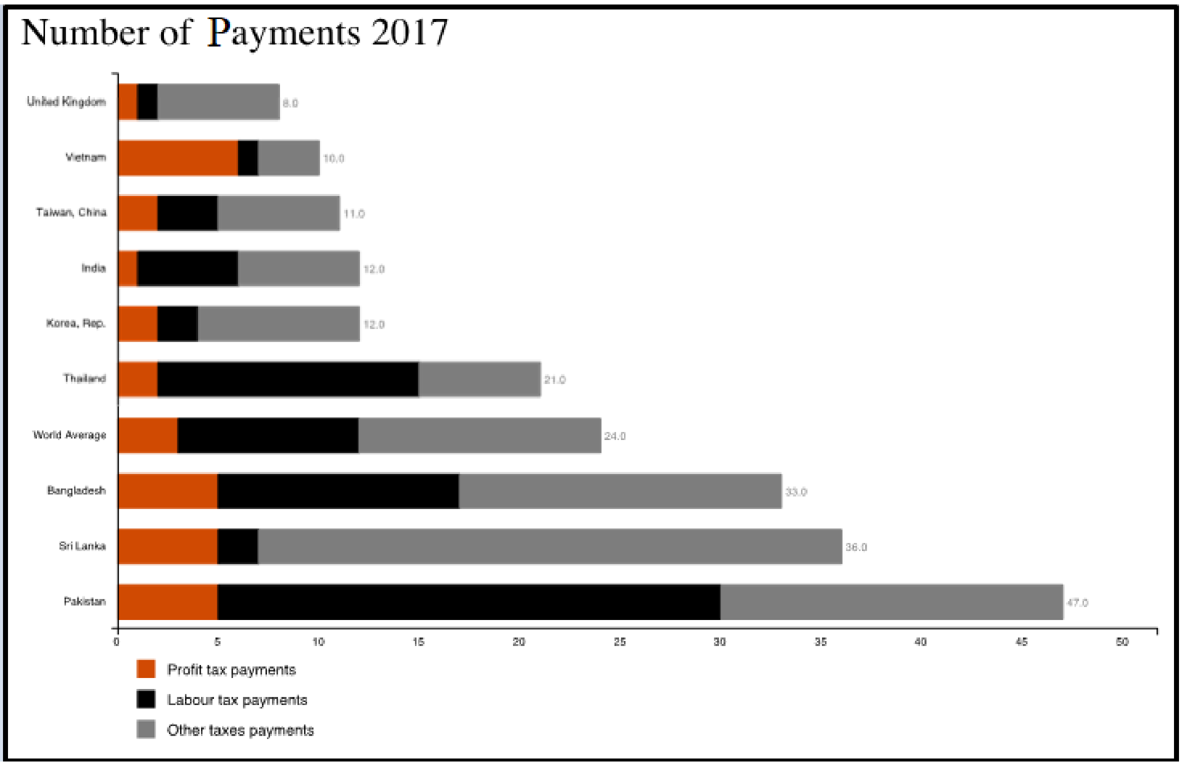

Figure 6: Benchmarking Pakistan's number of tax payments

Source: PwC Interactive Tax Data Explorer

Note: Some of the figures in the chart may be rounded.

In the focus group discussions, high tax rates in Pakistan were seen as a major disincentive for small firms to formalize. Reduction in tax rates would create incentives for SMEs, in particular small firms, to formalize and that would eventually broaden the tax base and increase overall tax revenues. Another related issue is that of high taxes on the manufacturing part of the value chain, as a result of which smaller vendors are able to avoid taxes by staying informal. Also, higher relative taxes have a direct impact on the competitiveness of SMEs especially the exporters.

In addition, there is a lack of harmonization of taxes between the provincial tax authorities and FBR leading to issues in tax refunds. There is also an issue of non-uniform taxes between provincial tax authorities. Consequently, businesses facing non-uniform tax rates are unable to get back input adjustment refunds and, in many instances, face duplicate taxes. Thus, there is a strong need for harmonization of taxes across the country.

Tax bureaucracy was reported by the stakeholders to be a major source of predation and corruption. The prevalent feeling is that the existing practice of placing extra burden on already registered firms is one of the primary reasons behind low firm formalization and corporatization.

Most of SMEs lack the capacity to fulfill legal, regulatory documentation and compliance requirements. Therefore, they struggle to meet these requirements and have problems filing tax returns. Also filing of appeal against assessment of tax is a difficult, costly and cumbersome process for SMEs.

The participants gave examples of firms who were served audit notices soon after they registered with the tax authorities. FBR was known to levy tax based on historical performance, even if the business incurs losses in a year. Therefore, tax lawyers have to be hired, which is yet another expense. For small firms with narrow margins, the possibility of legal recourse to tax problems thus becomes unaffordable.

Based on the stakeholder feedback and international best practices, the following are recommendations to improve the tax system and reduce the burden of taxation particularly on SMEs.

As a general fiscal and tax policy principle there should be an equitable distribution of the taxation burden through a broader tax base. For example, an estimated 58 percent of the taxation burden is borne by manufacturing which represents 13.5 percent of GDP. (Pakistan Business Council, 2018)

The number of taxes needs to be reduced. A national tax authority could be considered to unify filing of returns, settlement of liabilities and harmonization of taxes to avoid double taxation. Also, frequency of paying taxes which is currently 47 a year can be reduced. Taxes may be paid quarterly instead of every month.

The Government should ensure that the announced policy to reduce corporate income taxes for firms with a turnover of less than PKR 250 million from 25 percent to 20 percent by 2023 is extended to firms with a turnover less than PKR 650 million (Medium as per the proposed definition).

For small firms with a turnover of less than PKR 100 million (as per proposed definition of small firms) a presumptive tax option can be offered in which they pay 8 percent of their revenue. This scheme would ease tax compliance and filing process for small firms who would not have to keep detailed books of accounts (Singh, 2018).

The general sales tax rate should be revised downwards to ensure a level playing field between the formal and the informal sector, given the poor state of documentation of the economy.

In addition, in order not to disincentivize and impede Pakistan’s uptake of digital services, it is recommended to reduce or remove the fee on offshore digital services (FBR Finance Act, 2018).

The following taxes need to be removed.

1. Levy of Provincial Excise duty at import stage may be withdrawn.
2. Provincial Infrastructure cess of 2 percent should be withdrawn.
3. The archaic Motor Tax on horsepower in Punjab (local government) needs to be withdrawn.

FBR should compensate industries whose refunds are blocked for more than three months and allow adjustment of input sales tax against outstanding refund.

The following recommendations are aimed to ease the process of tax filing and collection.

The process of filing tax returns needs to be simplified and made more transparent to improve compliance and curb harassment of tax payers. Moreover, there needs to be an SME facilitation center at FBR, enabling them to provide direct, personalized and timely guidance to taxpayers on compliance.

Tax audits should be conducted independent of the taxation authorities as currently the FBR does both, acting therefore as both the judge and the jury. Also, tax notices are issued liberally to exert pressure on tax payers without any accountability of the tax official issuing the notice. The tax officials need to be held accountable in cases of frivolous tax notices (PBC, 2018).

3.3. Exchange Rate And Monetary Policy

Competitive and Stable Exchange Rate

An artificially overvalued exchange rate for the last five years made exports expensive and uncompetitive while lowering the cost of imported items. This contributed to the trade imbalance and resulted in the depletion of foreign exchange reserves. The recent sharp devaluation of almost 25 percent was required to bring the Rupee closer to its actual market value. Although this has resulted in a slight improvement in Pakistan's trade balance, the downside of a sharp devaluation is the sudden rise in the cost of imported inputs and inflation, hurting both producers and consumers in the economy. Also, as smaller adjustments and fluctuations in the exchange rate are less costly – gradual depreciation should be allowed in order to avoid an eventual large devaluation. Smaller firms, which have a high import content and operate on low margins, are particularly vulnerable to exchange rate shocks. Therefore, it is recommended that an overvaluation should be avoided and the exchange rate should remain competitive.

Interest Rate

One of the major constraints to SMEs is access and cost of formal capital. The cost of capital is determined by the interest rate set by the SBP. The recent inflationary pressure in the economy has resulted in an increase in interest rate, which is expected to go up further. This would impact firms that use the formal banking channels for investment and trade financing and working capital needs. Most of these firms, which have access to formal credit, are likely to be medium in size and some of them would be exporters as well. As a large number of small firms in both manufacturing and services sector are connected to medium firms through sub-contracting relationships, the impact of an increase in cost of borrowing would have a ripple effect across the economy.

For the past many decades, the government has been the major borrower from commercial banks. Given favorable interest rates, it was safe and profitable for the commercial banks to lend to the government. However, this policy has severely crowded out private sector lending. For the government to achieve private sector led growth it is essential that public sector lending from commercial banks be reduced.

Thus, a broad recommendation on monetary policy and -interest rates is to have a strong SME advocacy voice in the State Bank which represents the interests of the sector.

3.4. RECOMMENDATIONS

Trade Policy

- It is recommended that all the existing SROs be reviewed and revised into a consolidated SRO to be approved by the Fiscal Policy Board and the Parliament. Any new SRO shall be time bound and should go through the same process of approval.
- The trade and tariff policy shall be made in consonance with the Investment, Industrial and SME Policy and not determined by fiscal or revenue considerations of FBR.
- There needs to be a strong SME advocacy voice in the Commerce Ministry which represents the interests of the sector in trade policy formulation.
- Import tariffs on all raw materials, intermediate goods and machinery, which were increased from 0 to 3-5 percent in the last five years, shall be at zero tariff. Import tariffs on all the raw materials, intermediate goods and machinery at higher than 3 percent slab (11 percent, 16 percent or 20 percent slab) shall be brought down to zero - one slab down every two years. The current Duty and Tax Remission for Exporters (DTRE) scheme needs to be extended to both SME manufacturers and exporters and indirect exporters – vendor SMEs.
- It is recommended that industrial and commercial importers face the same import tariff regime.
- The Competition Commission shall ensure fair pricing by commercial importers and penalize formulation of cartels.
- The DTRE scheme needs to be simplified.
- Central bonded raw materials and intermediate goods warehouse facility shall be established.
- Pending payments (sales tax refund and duty draw backs) shall be disbursed immediately with priority given to SMEs. In the future such payments shall be made immediately by the State Bank as soon as export payments are received.
- It is recommended that duty draw backs be phased out and a reformed DTRE system be put in place instead.
- The government shall expedite the implementation of the National Single Window (NSW) system to ease customs procedures and reduce trade costs.
- A Model business-friendly custom clearance unit shall be established.
- Develop the analytical and negotiation capacity for PTA discussions with the objective of increasing market access/exports of SMEs.
- It is recommended that Pakistan's medium-term trade strategy shall focus on increasing regional trade, in particular with our neighboring countries such as India.

Taxation

- The number of taxes need to be reduced. A national tax authority shall be considered to unify filing of returns, settlement of liabilities and harmonization of taxes to avoid double taxation. Also, frequency of paying taxes which is currently 47 a year can be reduced.
- Extend the announced policy to reduce corporate income taxes for firms with a turnover of less than PKR 250 million from 25 percent to 20 percent by 2023 to firms with a turnover less than PKR 650 million.

- For small firms with a turnover of less than PKR 100 million a presumptive tax option can be offered in which they pay 8 percent of their revenue.
- The general sales tax rate should be revised downwards.
- In order not to disincentivize and impede Pakistan's uptake of digital services, it is recommended to reduce or remove the fee on offshore digital services.
- The following taxes need to be removed.

    1. Levy of Provincial Excise duty at import stage may be withdrawn.

    2. Provincial Infrastructure cess of 2 percent should be withdrawn.

    3. The outdated Motor Tax on horsepower in Punjab (local government) needs to be withdrawn.

- FBR shall compensate industries whose refunds are blocked for more than three months by allowing adjustment of input sales tax against outstanding refund.
- The process of filing tax returns needs to be simplified and made more transparent.
- There needs to be an SME facilitation center at FBR, enabling them to provide direct, personalized and timely guidance to taxpayers on compliance.
- Tax audits shall be conducted independent of the taxation authorities.
- The tax officials need to be held accountable in cases of frivolous tax notices.

Exchange Rate and Interest Rate

- Sharp changes in exchange rates and interest rates shall be avoided.
- A strong advocacy rate of SMEDA is recommended on both monetary policy and exchange rate management.

3.5. MONITORING AND EVALUATION

- For Trade Policy the most important KPI is the annual increase in exports. A related KPI for performance of exports and market access is also exports to new markets.
- For taxation, KPIs to monitor include: number of SMEs filing taxes and value of taxes collected from SMEs. The frequency and the extent of complaints registered at the SME facilitation desk at FBR (recommended in policy) would help monitor and evaluate procedural changes in FBR meant to ease tax compliance.
- For exchange rate and interest rates, the KPI is stability of both the macroeconomic variables.

4. REGULATORY INTERFACE

The regulatory interface of governments with SMEs covers several aspects in the lifecycle of a firm e.g. licensing and registration, contract enforcement, insolvency and bankruptcy, labor and employee regulation, taxation, entry and exit requirement, and sector-specific regulations. Details of some of these regulations are provided in Annex 1.

The regulatory burden imposed by this interface is an important impediment for Pakistani firms, as discussed in detail in the Inception Report. Corruption is the most important constraint reported by Pakistani firms in the World Economic Forum's Global Competitiveness Index (GCI) and the second most important constraint reported in the World Bank Enterprise survey. Inefficient government bureaucracy is also in the top five constraints. While regulatory burden impacts all firms, there is a substantial body of evidence that SMEs suffer more than large firms. As discussed in the Inception Report, as compared to large and micro firms, small and medium sized firms in Pakistan are more likely to report corruption as a severe obstacle and report corruption during visits from government officials, and are more likely to have had bribed a public official. They also report over twice as many visits by tax officials, and are three to four times more likely to have paid a bribe to a tax official. This is not just a Pakistan specific problem. Even in the EU, for example, small firms spend ten times more per employee on regulatory compliances than large firms. Medium sized firms spend four times more per employee (Expert Group, 2007).

There are several reasons for this disproportionate burden. Firstly, regulatory costs are largely fixed (e.g. record keeping), and so they form a larger fraction of the costs of smaller firms. Secondly, larger firms are able to hire dedicated specialists to look after their compliance needs. In very small firms the entrepreneurs, who are the most valuable resource, usually undertake this function themselves, which diverts them from the critical task of firm growth. Several firms that were interviewed specifically spoke about this as the key deterrent. As soon as the firm formalized, they had to divert their own time towards meeting regulations and dealing with government departments rather than their core business.

In section 4.2, this chapter discusses a crosscutting approach to reducing red tape and regulatory burden in general, which impacts all firms, but affects SME disproportionately. Section 4.3 explores regulatory tiering by which SME specific measures can be undertaken. Section 4.4 discusses some specific approaches to easing compliances, and finally Section 4.5 discusses regulatory impact assessments, outlining an approach that ensures that new regulations do not come at a disproportionate cost to businesses.

4.1. CROSS-CUTTING MEASURES TO REFORM REGULATION

If left unchecked, regulations have a tendency of piling up. New regulations are typically added as required, without a symmetrical removal of regulations that are no longer required. Many of the compliances required are therefore irrelevant or outdated, which makes them impossible to comply with at a reasonable cost. Consequently, many small firms are non-compliant.

Government officials use this non-compliance to extract informal payments, adding hassle, time and cost to the firms with no discernible benefit (e.g. consumer or worker safety or competition, environment etc.). Examples of this that were brought up by stakeholders include the requirement to maintain paper records of worker attendance even when firms have moved to biometric attendance systems, white-washing walls requirements even for "clean" production processes, and metal plumbing requirements at a time when pipes are now entirely plastic based.

There are several examples of systematic approaches to remove unnecessary regulatory burden. Denmark's Business Forum for Simpler Rules, for example, identified business regulations that were perceived as most burdensome and simplified them based on a "comply or explain" principle. Similarly, the Burden Hunt program in Sweden and Denmark engaged civil servants, in consultation with the private sector, in developing regulations that reduced red-tape. Another example is the United Kingdom's (UK) Red Tape Challenge website which was used to invite comments on reducing the burden of existing regulations, which led to the design of a package of 3000 red-tape reducing reforms (Organization for Economic Cooperation and Development, 2018).

An approach that builds on successful regulatory streamlining experiences of OECD countries is the Regulatory Guillotine™ approach, which has been used in a dozen countries including Thailand, Egypt, Vietnam, Mexico, South Korea, Kenya and Ukraine.

The Guillotine provides a mechanism and online tool for counting and rapidly reviewing a large volume of regulations with the aim of discarding regulations that are no longer needed, and simplifying those that are needed and legal, but not business friendly. The reform process is spearheaded by a small, central unit set of by the government. The steps are:

- *"The government rapidly counts all regulations or formalities affecting businesses. The inventory is placed into a database. In many countries, this is the first complete inventory of regulations and is a significant benefit.*
- *Each rule or formality is reviewed three times by 1) civil servants in ministries, 2) by business stakeholders, and 3) by the central unit.*
- *Each rule or formality is reviewed against simple filters in a checklist format.*
    - *Is it legal?*
    - *Is it needed?*
    - *Is it business friendly?*
    - *Are fees necessary and reasonable?*
- *After review, each rule or formality is placed into one of three categories: maintain, simplify, or eliminate.*
- *The Council of Ministers and Parliament, by an omnibus process, takes the steps needed to eliminate regulations not needed and simplify regulations that are too complex.*
- *The remaining rules or formalities are placed into a permanent registry where users can find information, download forms, and apply for permits. This registry can be the basis for a One Stop Shop if desired.*
- *The reform moves from start to finish in 18-30 months."* (Jacobs Cordova & Associates, n.d)

Results include the elimination of 50 percent and the simplification of 22 percent of the 11,000 regulations in South Korea in a period of 11 month, and the elimination of 54 percent and simplification of 27 percent of 2000 regulations in Mexico in nine months.[12]

The approach is recommended for Pakistan both due to the large volume of outdated regulations and also because business friendliness is not explicitly an objective of the regulatory authorities. However, the challenge is that most regulatory authorities are in the provincial domain, which makes is difficult for regulatory reform to be led by the Federal Government. Nevertheless, the Federal Government can build ownership and consensus for a concerted effort to engage in a nationwide exercise to reduce regulatory burden.

It is recommended that this approach also be used for sector specific regulations such as those related to restaurants, logistics and e-businesses. In the stakeholder consultations several issues were raised regarding inappropriate sector specific regulations, which add costs to businesses with no discernable gain for consumers. Many of these arise from vague, incomplete regulations with improper implementation mechanisms. Part of the exercise of clarifying the regulations that are necessary and legal should be the removing ambiguity in the rules.

4.2. REGULATORY TIERING

Apart from crosscutting measures, specific measures for SMEs such as exemptions or reduced obligations can assist in filtering out compliances that are not size appropriate. Such exemptions should, however, be considered with care to ensure that firms are not disincentivized to grow. In addition, it should not give firms a license to operate in a way that is damaging to the public interest. Nor should the differentiation come at a disproportionate cost to the regulatory agencies that implement the regulations.

The idea is to identify regulations where there is a particularly disproportionate burden on small or new firms, and design a graduated structure that does not significantly compromise the regulatory purpose. The exemptions are justified both on grounds of equity and efficiency. A disproportionately high cost of compliance for small firms would mean that they are unfairly disadvantaged over large firms, which has implications for market power and competition.

A starting point for this is engagement with small and new businesses to identify those regulations that are particularly burdensome, and to adopt a consultative approach to address them with the relevant departments and businesses. The proposed SME Portal, discussed in more detail in Section 12, is an ideal tool to leverage for this.

Asia-Pacific Economic Cooperation (APEC) (2015) describes several examples of regulatory tiering. For example, Canada has adopted regulatory tiering with reference to tax compliances and rates by allowing eligible SMEs to report sales and Government

[12] More results are available at http://regulatoryreform.com/regulatory-guillotine/

Sales Tax (GST) tax information annually as opposed to quarterly for medium-sized firms, and monthly for large firms. This simplifies their accounting process and also reduces the frequency of tax payments, leaving them with greater liquidity through the year.

Chinese Taipei also provides special tax treatment for SMEs. The National Association of Small and Medium Enterprises (NASME) in Chinese Taipei acts as the coordinating body and advocacy agency for SMEs by putting forward the concerns of SMEs and ensuring the government policies are aligned to them. NASME also acts as a counselor for SMEs and coordinates meetings with specialists and academics to discuss the feasibility of regulations. Specific examples include tax on the transfer of land that will be used for SMEs to be paid in five installments instead of a lump sum at the time of transfer. In addition, SMEs are allowed to retain a larger portion of their surplus earnings, and consequently to defer their taxes and increase immediate working capital. SMEs are also able to receive credit of up to 30 percent of their annual income tax for R&D investments, and are able to claim accelerated depreciation on purchases of R&D related equipment. In certain conditions, SMEs are also able to deduct 130 percent of gross salary payments from taxable income for new domestic employees hired. Small, unincorporated businesses are also exempt from monthly submissions of tax receipts. Instead a fixed levy is paid quarterly.

In Singapore, small companies benefit from exemptions from statutory auditing requirements. Instead, companies with both annual turnover and assets under Singapore Dollar (SGD) 10 million, and under 50 employees can submit a declaration of solvency signed by the directors and company secretary. Alternatively, they can submit unaudited accounts. The idea is that since SMEs have limited public interest, there is no need for mandated audits. The exemption saves each company approximately SGD 3000. Similar exemptions are also available in Malaysia, UK and Australia.

The process followed is important too. The Ministry of Finance in Singapore consulted extensively with companies, associations, law firms, government agencies and auditors in identifying the specific requirements that could be relaxed for SMEs, ensuring that the exemptions are in line with the regulations that are most burdensome for SMEs, and that will not hurt public interest to exempt. In addition to auditing relaxations, Singapore also has a platform to allows SMEs, intellectual property owners, potential buyers and sellers and licensees to come together to commercialize intellectual property assets.

In Japan and Korea too, there are reduced fees, faster processing and capacity building for intellectual property protection applications.

These examples are illustrative. The regulations that impede SMEs disproportionately for Pakistan need to be identified through a consultative exercise, with a permanent body in place to ensure that the voice of SMEs is heard and the issues are resolved through cooperation with the relevant institutions.

4.3. EASE OF COMPLIANCE

For the remaining regulations that are both important and relevant for SMEs, a further issue is ease of compliance. SMEs feel encumbered and threatened by government officials, rather than facilitated in complying. Business across the board felt that the process of compliance is made deliberately difficult in order to allow officials to seek informal payments. This acts as a deterrent for firms to grow and formalize. In fact, even registered firms report greater harassment from FBR as their revenues and taxes grow.

Some specific suggestions for easing compliance that arise from the stakeholder exercise and from other recent work on SMEs in Pakistan (discussed in detail in the Inception Report) are outlined below. The Regulatory Guillotine suggested in Section 4.2 is likely to identify further business unfriendly regulations in a systematic manner. The reforms that arise from that exercise should be added here.

Registration Facilitation

Registering a firm with SECP can be a time-consuming process. The following recommendations can help expedite this.

1. A database of patents and names/logos already taken can be developed so firms get instant feedback if the name they have proposed has already been taken. As things stand there is a delay between each proposed name and the approval.
2. Single portal registration: There are multiple departments that a firm must register with, such as Employees Old-Age Benefits Institution (EOBI), PESSI (Punjab Employees Social Security Institution), Department of Labor etc. Data that is taken from the firm when registering with SECP can be shared with the remaining departments for automatic registration.
3. Firms complain that they do not know what compliances are required of them, and the first time they learn of them is when they are raided and fined. Therefore, at the time of registration, clear information should be given on applicable regulations and compliances, the dates by which they are required to comply, and the penalty for non-compliance. Additionally, training and support by the relevant department should be offered to newly registered firms and information on this training/support should be part of information package provided at the time of registration. This measure shares the responsibility of information and training with government departments, and reduces liability of firms till they have been given reasonable space to comply.

Business Friendly Inspections

Related to the regulatory interface, there are multiple visits to firms by regulatory agencies (such as Department of Labor, Department of Environment, Parks and Horticulture Authority (PHA), Food authorities). Firms perceive these visits as hostile. They are also reportedly predatory, based on a “raid and seal” approach, with associated informal payments. The following process is suggested to help achieve the intended purpose of the inspections in a business-friendly manner.

- Firms submit a self-assessment of their compliances annually, with a select sample being cross-checked by the authorities
- The inspections can be merged for the purposes of inspection visits, so that the number of visits by government officials is minimized
- A warning can be issued on first instance of non-compliance with written guidelines on what is expected and by when
- Support can be offered to SMEs to help build capacity for meeting compliances, such as the trainings currently offered by Punjab Food Authority
- Fine/sealing to take place only after this process is followed

Approvals and Licenses

Single access points for firms, where an existing agency brings together representatives of other agencies, can reduce processing times. This goes beyond one-stop-shops, which can in practice become places that will deliver application documents to other agencies, thereby not reducing processing times at the back-end. Successful examples include Portugal, where the number of visits required for company registration went down from 11 visits to 3. Other countries with positive experiences include Estonia, Finland, Morocco, Thailand and the United Kingdom (World Bank, 2005).

Another way to reduce processing times for standard licenses and approvals is the "silence is consent rule". For certain licenses and authorizations, the law guarantees a response from government within a specified number of days from application. No response means that the approval is granted automatically (De Rosa, Lotty, Pirlea, Aprahamian & Stanescu, 2013). This rule is used in Italy, Romania, Armenia, Georgia and Morocco.

Use of Technology

The use of digital technologies is helping bring down compliance and registration costs across the globe. For example, Switzerland has recently launched an e-Government platform. This platform manages the government's interaction with firms in a customer-centric way, providing a secure place for processing authorizations, applications and reporting. It is also an easily accessible source of information.[13] In addition there is an exclusive website for SMEs, with customized details to assist SMEs in registering, trading, with finances etc.[14] Such portals can also be used to engage stakeholders in the reform process, by soliciting feedback at all stages of reform.

Simple legislations such as those that allow electronic signatures have been used in countries like Australia, Canada, Vietnam and Singapore, cutting processing time by 50 percent on average (World Bank, 2005).

Tax compliances have also improved with the targeted use of technology. These can be used to build-in compliance as part of the system of receiving payments. For example, Chile uses an Electronic Invoicing System that allows firms to issue and receive invoices that are made available simultaneously to tax authorities. This system provides a free, simple and complete accounting service to firms (OECD, 2018).

4.4. Adding New Regulations

Keeping the regulatory framework business friendly is not just about reforming the stock of regulations, but also about the process of creating new regulations, which ensures that the overall regulatory burden is kept in check.

One of the ways that governments have addressed this is by using rules to remove old regulation for every new piece of regulation. For example, the UK has built on the success of the One In One Out (OIOO) rule to add One-In, Two-Out and finally One-In, Three-Out in 2016. The rule applies to all new UK legislations that impose a direct net cost on business or civil society, proposing that for all such legislations, the departments must identify and remove existing regulations with an equivalent of three times the net

[13] The platform can be accessed at https://www.easygov.swiss/easygov/#/
[14] This website can be accessed at https://www.kmu.admin.ch/kmu/en/home.html

value of costs. Departments are required to evaluate and report costs with every proposed regulation (Department for Business, Innovation and Skills, 2011). These rules aim to reduce the cost and volume of regulation in the economy, and encourage departments to implement regulations only after considering non-regulatory alternatives.

Regulatory Impact Assessment (RIA) is another standard evaluation tool that can be customized to include assessment of the impact for SMEs as a specific category. In the EU for example, the SME test is a part of the "Think Small Principle" which uses consultations with SMEs and identification of affected businesses to measure the impact of SMEs through a cost-benefit analysis. It also considers alternative mechanisms and mitigating measures that can be taken to reduce the regulatory burden of proposed regulations (OECD, 2018). These can include regulatory tiering.

Examples of this include the US Regulatory Flexibility Act, which requires government agencies to assess the impact of their regulations on small business. The Small Business Administration also intervenes to represent the views of small businesses in the rule making process. It is estimated that this SME-friendly RIA approach has saved the economy USD 150-200 million annually (APEC, 2015). Another example is the collection of data to estimate regulatory compliance costs for SMEs in Canada (by Statistics Canada). The Canada Revenue Agency has also developed a performance-monitoring framework to assess regulatory compliance issues for SMEs using both direct (time and cost) and indirect metrics (APEC, 2015).

4.5. Analysis Of Recommendations From SME Policy 2007

Under the section on business environment, the SME Policy 2007 made the following recommendations specifically for reducing regulatory burden for SMEs.

1. *"The Federal Government may encourage periodic review of all fiscal laws in force with a view to facilitate and improve growth of the small & medium enterprises.*

2. *Periodic review of Labor Legislation with a view of facilitating small enterprise growth may be undertaken whereby applicability of certain laws may be relaxed for SMEs for a certain period of time. However, provision of education/assistance to SMEs to achieve proper safety at work and compliance with international conventions shall be essential.*

3. *SME Desks may be established at the Federal, Provincial, Banking and Tax Ombudsman Offices for handling and addressing SME grievances. The Complaint Cell established at State Bank of Pakistan may also facilitate redressal of SME complaints.*

4. *Government of Pakistan (GOP) may consider to support establishment of an SME Promotion Council (including its local chapters) and SME specific Trade*

Associations for organizing SMEs and providing them with a platform to lobby for favorable government policies.

5. *Capacity building and strengthening of existing Chambers of Commerce and Industry (CCIs) and Trade Associations (TAs), may be under taken, making them more effective for supporting their members including SMEs, with special focus on World Trade Organization (WTO) & its impact on local industry. Moreover, Government functionaries in tax, registration, labor, etc. departments are proposed to undergo specialized training for handling SME related issues.*

6. *Genuine SME representatives are proposed to be inducted in all federal monitoring and dispute resolution schemes with private sector participation.*

7. *Regulatory regime for specialized sectors in provinces (such as mining) may be developed as per their specific requirements keeping in view their regional dynamics.*

8. *GOP may follow an effective strategy to reach out and communicate with SMEs using appropriate electronic and print media. Regulatory compliance procedures will be widely communicated to SMEs. Communication will increasingly use Urdu & local languages where useful.*

9. *Improving and enforcing Intellectual Property Rights for SMEs."* (Small and Medium Enterprise Development Authority, 2007)

Key components from the analysis in this section are reflected in the recommendations, though sometimes implicitly: a participatory approach in which SMEs can identify problematic regulations (Recommendations 3, 4 and 6), information dissemination and assistance with compliance (Recommendations 2, 5 and 8), regulatory tiering (Recommendation 2), streamlining regulations (Recommendation 1) and making regulations more appropriate (Recommendations 5 and 7). Most of these recommendations are all valid today as well. Section 4.7 extends these recommendations by providing specific systematic mechanism to allow effective implementation.

4.6. RECOMMENDATIONS

In light of the preceding discussion, the following measures are recommended in order to reduce the regulatory burden.

1) A regulatory guillotine be initiated immediately to streamline the existing stock of regulations.
2) A process be selected by which new regulations are evaluated for the costs to business and designed in a way that minimizes these costs. This can be done through:
   a) Regulatory Impact Assessments, with a specific assessment for small businesses.

b) Regulatory tiering if the costs to SMEs are disproportionately high, and if the regulation is not relevant to SMEs. Reduced or delayed compliances should also be considered for new firms.
c) A simple rule of removing old regulations with the same net costs as the proposed new regulation can help keep costs low.

3) While the regulatory guillotine will systematically identify excessive regulations, in the interim period, a few reforms can be initiated immediately:
   a) Facilitating registration by creating an online database of names, logos and patents that can be checked in real time by firms when selecting a name.
   b) Single portal on-line registration that automatically registers the firms with selected agencies such as EOBI, PESSI, Dept of Labor etc. A single unique identifier will issue to all registered firms that can be used with all government departments to pull up relevant data electronically, precluding the need to enter information separately.
   c) Provision of clear information of required compliances at the time of registration, the dates by which firms are required to comply, and the penalty for non-compliance. No penalties can be imposed for information that has not been shared earlier.
   d) Additionally, training and support by the relevant department should be offered to newly registered firms and information on this training/support should be part of information package provided at the time of registration.
   e) A process for business-friendly assessment of compliances that minimizes inspections. This can include self-assessment and reporting online, with a select sample of firms being cross-checked each year by authorities. A warning on non-compliance and written guidelines of what is expected and by when should be given before raiding and sealing.
   f) A clear time-line should be given for processing selected licenses and approvals, with automatic approvals if the processing time is exceeded.
   g) Technology should be used wherever possible for simplifying and expediting the interface with government. Examples include merging invoice systems with tax submissions, and using unique company identifiers that are recognized by all government agencies. This reduces the information that firms are required to complete in every interaction, as government departments can use the unique identifier to access the data.
4) A formal forum of consultation with SMEs, with capacity to outsource analytical support, and that can be used for advocacy is critical to ensure that rule making is sensitive to SME costs. This can include online forums hosted by SMEDA where firms can register their inputs on regulatory topics, on similar line to citizen's compliant portal. This can be hosted within the SME Portal suggested in Section 12.

4.7. Monitoring And Evaluation

The Doing Business survey already collects detailed data annually on the time taken and cost of compliance of regulations. This data can be used to benchmark progress on regulatory burden instead of duplicating data collection, and only collect that data which is not available through a published source, e.g. Environment Regulations.

For regulatory guillotine the following indicators will be used.

- Number of regulations eliminated (Net)

- Number of regulations modified
- Reduction in fees and regulatory charges
- Approximate cost savings to businesses

To check progress on process, the intermediate inputs can also be monitored and evaluated: formation of a forum for consultation, number of meetings of the forum *on the specific topic of regulation* and follow ups with the relevant departments, creation of online forum with the option to provide feedback on regulatory issues, initiation of regulatory guillotine and the chosen mechanism of keeping the costs of regulations low and notification of a change in the compliance and inspection procedure.

5. MARKET ACCESS

The evidence gathered in the field survey indicated market access, both local and international, to be one of the key constraints impeding growth of SMEs across the country. Small firms and businesses located in rural and remote areas, such as in Balochistan and Gilgit Baltistan, find it difficult and costly to access major cities and markets within the country. Lack of information, inadequate marketing, infrastructural and logistical problems are the main barriers preventing firms located in these areas from selling products or services to markets in the major cities of the country. Moreover, the survey indicated that with the exception of the main export clusters, such as in Sialkot, Lahore and Karachi, most of the SMEs in the country do not have the resources, capability or competitiveness to access international markets. This fact is reflected in the chronically low and stagnant exports of the country. As mentioned earlier in this report, Pakistan's export performance has been particularly poor over the past five years. The main reason behind this is declining productivity and competitiveness of exports along with lack of product diversification and limited international market access. Almost 60 percent of Pakistan's exports comprise of Textile and Clothing, while 50 percent of the export market is limited to just four destinations– US, Europe, China and Afghanistan. As discussed before, trade potential within the region remains severely under-exploited and new markets for exports within the developing world remain untapped. The figure below shows the range of interventions that have an influence on SME export market access. Some of the key interventions that involve both the public and private sector are in product standards and certifications, BDS, marketing strategies, technology such as e-commerce and leveraging MNCs to integrate SMEs in GVCs.

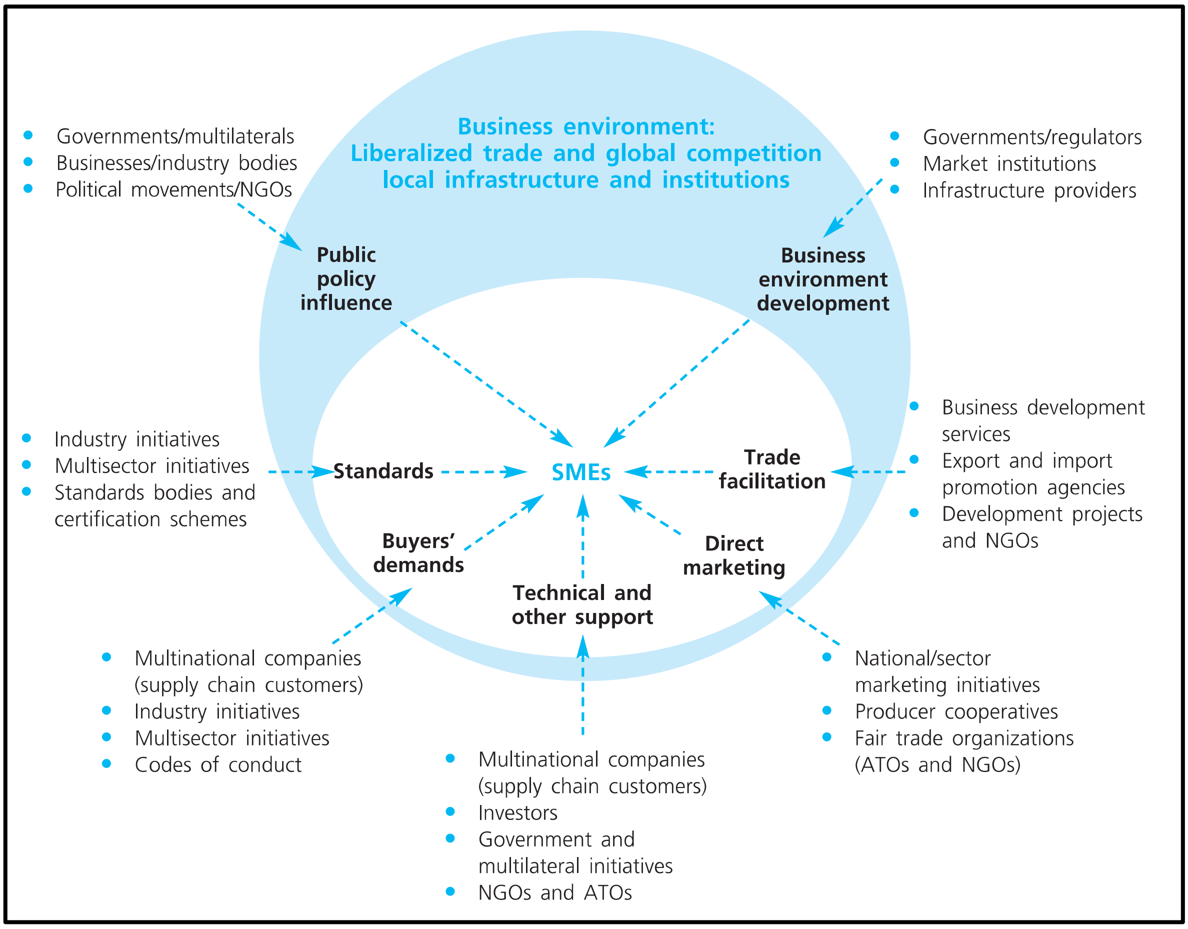

Figure 7: Interventions influencing SME export market access

Source: Forstater, MacGillivray, & Raynard, 2006

The following set of recommendations for improving both local and international market access for SMEs have largely been drawn out from the stakeholder meetings across the country and the SME Policy 2007. These recommendations are partially based on the framework of market access interventions described above. They also take into account the challenges and opportunities of marketing for SMEs brought about by the current digital/ internet based 4th Industrial Revolution.

5.1. Trade Fairs, Exhibitions And Emporia

Like most other developing countries, Pakistan exhibits stark differences in access to information, markets and technology across provinces and between urban and rural areas. SMEs in and around big cities, like Karachi and Lahore, generally have access and information about markets, use technology such as the internet and are likely to be better informed about government trade promotion programs and initiatives. In contrast an SME in a smaller town or in a less developed region such as Balochistan or certain parts of Khyber Pakhtunkhwa (KPK), might not have any of these basic facilities, severely constraining its ability to market and sell products or services even locally.

A major issue raised by SMEs across the country, particularly those in Gilgit-Baltistan (GB), Khyber Pakhtunkhwa (KPK) and Balochistan, was the lack of facilitation and support received from the relevant government agency (Trade Development Authority of Pakistan) in accessing international markets. Small firms in particular complained that they did not have any information about international trade fairs nor were they ever approached by TDAP to participate in such fairs to exhibit their products. Those that had information about international trade fairs, found it too costly to attend. For example, floriculture in Quetta, Balochistan has tremendous export potential but is disconnected from both local (Lahore, Karachi) and international markets (United Arab Emirates (UAE), Saudi Arabia etc.). Similarly, in KPK and GB, gems and jewelry, dried and organic fruit are potential export clusters but are not on the radar screen of TDAP. Therefore, it is recommended that TDAP in collaboration with AHAN[15] organize and facilitate the participation of small firms in international fairs and exhibitions on subsidized rates. There should be an SME quota in all trade delegations supported by TDAP. TDAP should specifically target SME clusters such as in Balochistan, KPK and GB, which are disconnected from markets because of both remoteness of location and lack of information. The SME quota should have a significant share of women led businesses. Private sector firms can be hired for organizing, marketing and exhibiting products at international trade fairs. The source of financing for SMEs in international trade fairs can come from the BDSF which can receive a certain percentage of the EDF dedicated for the purpose of SME export promotion.

For improving local market access of small businesses and cottage industries in remote areas, there should be regular trade fairs and exhibitions in all the major cities of Pakistan. These trade fairs and exhibitions could be organized by AHAN in partnership with the provincial industry departments. Also, it is recommended that permanent emporiums be established in major cities to exhibit the arts, crafts and cuisine of all provinces and regions of the country. The stalls in these emporia could be rented out on

[15] AHAN - Aik Hunar Aik Nagar (one village one craft) is a section 42 company established in 2007 under the administrative control of the Ministry of Industries and Production, GOP. The company aims to promote and develop micro and small non-farm businesses (local crafts and wares) in rural areas across the country.

a rotational basis and at a subsidized rate to registered small businesses. SMEDA and AHAN could develop a proposal modelled after the State Emporiums in India and the 'Delhi Haat' which is a cottage industry and food emporium. This proposal could be piloted in either Lahore or Karachi before being replicated in other cities.

5.2. Cluster Based Marketing Strategy

Small firms generally do not have the resources for extensive marketing strategies and programs. Therefore, support services and matching grants need to be provided to SMEs for marketing purposes. In the presence of resource constraints at the firm level, a cluster or sector-based approach can be adopted to leverage the private sector more effectively. The private sector and cluster associations can be incentivized to establish SME sector specific export marketing companies. The incentives provided by the government (SMEDA) can be in the form of matching grants for conducting international marketing research, developing marketing strategies, developing marketing material, packaging, branding, participating and conducting trade fairs and undertaking promotional and marketing activities (SME Policy, 2007). In addition, SMEDA can replicate Singapore's SME Market Access Program, that part-funds design, franchising, licensing, product listing fees etc. to help SMEs expand access to foreign markets. Matching grants can also be provided to sector associations for developing trade and product directories for major SME clusters (SMEDA, 2007). Funds for these initiatives can come from the BDSF.

5.3. Standards And Certification Infrastructure

A critical weakness across manufacturers in Pakistan is variations in product quality, standards compliance and poor packaging facilities. The lack of product quality – standardization, compliance and certification - is perhaps the most binding constraint to export, especially to high income markets. This is particularly the case with SMEs, preventing them from accessing the international market.

As a first step it is imperative to develop national product standards that will allow industries to operate and market products across the country. At the same time implementation of harmonized standards by provincial authorities will ensure consumer safety. These standards should extend to imported products, especially packaged foods, for which English or Urdu language labels/ingredient lists should be a requirement. It is therefore recommended that in the medium term the role and effectiveness of Pakistan Standards and Quality Control Authority (PSQCA) and Pakistan Council of Scientific and Industrial Research (PCSIR) in helping and facilitating SMEs meet international quality standards be reviewed. The gaps and weaknesses identified in facilitating product quality and standardization should be subsequently addressed within a clearly specified timeframe. Improvement in PSQCA testing capability will help regulate the sale of sub-standard and about-to-expire local and imported products.

Internationally recognized certification institutions/labs should also be set up in the country to facilitate SMEs meet global standards. As some of these international standards certifications are expensive to acquire, it is recommended that SMEDA provide financial support for SMEs to meet these costs. The BDSF can be used to partially subsidize the costs of certification. In Korea, for example, Ministry of SMEs and Start-ups provides 50-70 percent of the costs required to acquire overseas standards certifications.

5.4. DIGITAL PLATFORMS AND E-COMMERCE

As mentioned before, we are in the age of the 4th industrial revolution brought about by digital technology and the internet. Traditional business services such as information about markets, access to finance and logistics are fast diffusing into a singular modern business eco-system through digital platforms. To illustrate this, according to United Nations Conference on Trade and Development (UNCTAD) e-commerce retail sales worldwide was around US$ 2 Trillion in 2016 with the global e-commerce market estimated at US$ 22 Trillion. In comparison, Pakistan's e-commerce market is estimated to be between USD 100 Million and USD 600 Million - a small fraction of the world market (Draft report on E-commerce, WTO and Development, n.d.)

Digital platforms improve SME competitiveness in multiple ways. These reduce costs of market entry and transactions; provide wider access to buyers and suppliers; are portals of information; improve access to different and innovative types of financial capital and also lower gender bias (International Trade Center, 2018). The potential of digital platforms such as E-commerce in connecting SMEs in Pakistan to both local and international market is tremendous. However, the current legal/regulatory framework is limited to standard retail transactions i.e., manufacturer, distributor, retailer or service provider who use their own website to sell products or services. The framework does not cover the most commonly used e-commerce business model which is the 'Online Market Place' where the e-commerce platform acts as a facilitator of services between a buyer and a seller. Examples of such models in Pakistan are daraz.pk and yayvo.pk amongst others. (Draft e-commerce regulatory framework, n.d.)

The government is in the process of developing a comprehensive e-commerce regulatory framework. The working group on the e-commerce framework has put forward a set of recommendations which cover consumer protection, personal data protection, cross border online transactions, registration and taxation. (Draft e-commerce regulatory framework, n.d.). It is expected that implementation of the e-commerce framework would incentivize and facilitate the establishment of 'Online Market Place' which would in turn help SMEs market and sell their products locally and internationally.

The main facilitating technology behind the success of E-commerce is 'payment gateways' such as PayPal. The State Bank should expedite the approval of applications by local investors to operate such payment gateways. Also, there is a need in the country for a *digital highway*, which connects financial institutions on a single platform easing online payment processes. The presence of local payment gateways and a *digital highway* would potentially attract large international players such as PayPal to start operations in Pakistan (Pakistan Economic Advisory Council, 2018).

Incentives such as matching grants can be provided by SMEDA to Information Technology (IT) start-ups for establishing Online Market Places and Payment gateways, which focus on SMEs. SMEDA in partnership with the private sector can also offer trainings to SMEs on the use of 'online market place' or digital platforms and 'payment gateways' (Pakistan Economic Advisory Council, 2018).

5.5. FOREIGN INVESTMENT, GVCS AND SMES

With the lowering of trade barriers, production of goods has been fragmented across the world leading to the emergence of GVCs. A country's involvement and position in a GVC is primarily a function of its competitive advantage determined by factor endowments and level of technology. With increased productivity of factors of production and improved technology, a country can attract high productivity foreign direct investment and move up the global value chain, speeding up the process of growth and development.

For Pakistan, the challenge for SMEs is to become part of GVCs and simultaneously climb the technology ladder. The development of SEZs under CPEC has provided an opportunity for that through FDI joint ventures conditioned on technology transfer, local sub-contracting and exports.

FDI can be an important vehicle for building up the value added by SMEs. Multinational firms bring technology and know-how to the local economy, and generate demand for local services and goods in their value chains. Pakistan can leverage its large and growing domestic market to attract FDI and connect to GVCs, such as in garments, auto, engineering, electronics, mobile phones etc.

Existing MNCs in the auto, light engineering, food and personal care sectors, can be given incentives to export from Pakistan linked to their domestic market expansion plans. These MNCs have sub-contracted upstream and downstream links with a range of local SMEs. Through export platform FDI, local SMEs become part of GVCs and benefit from better and more efficient production methods, improved management practices and technology spillover effects (Pakistan Economic Advisory Council, 2018).

Similarly, international supermarket chains can connect Pakistani exporters to the agribusiness GVC. This could be placed as a condition for approving acquisitions of existing businesses by international companies. This export focus in the foreign investment policy should be announced immediately to ensure that foreign firms currently looking to invest in the country can factor this into their plans (Pakistan Economic Advisory Council, 2018).

There are policies that can be undertaken to promote the spillovers from multinationals that incentivize them to source locally and invest in their suppliers. Malaysia's Industrial Linkage Program allows five-year income tax exemptions and 60 percent Investment Tax allowance on qualifying capital expenditure for SMEs that undertake certain kinds of activities and that are suppliers to Transnational Corporations (TNCs) or large companies. Another example is Malaysia's Global Supplier Program, which offers 80 percent training grant for SME employees in firms that supply to multinationals, and for training programs whose curricula are designed by the multinationals. Chile also offers support for SMEs in the value chain of large MNCs through its Supplier Development Program.

Investment tax allowances can be considered for SMEs in Pakistan that are suppliers to TNCs or large companies. Expenses that build capacity required by MNCs e.g., licensing, labor training, technology upgradation, improvement in management practices, can be made tax deductible. Matching grants for employee training programs can also be extended to SMEs that supply to multinationals.

In another example, the Malaysian Industrial program allowed foreign investors to deduct expenses of SME development (such as training, product development and testing and auditing) from their tax liability. In a similar vein, foreign firms in Pakistan can be exempted value added taxes on domestic products, to encourage local sourcing. They can also be given specific tax incentives tied to local sourcing and to product and Human Resource (HR) development of local suppliers. To implement these recommendations, SMEDA is required to play a strong advocacy role with the Federal Board of Investment to negotiate greater engagement of MNCs with vendor SMEs.

Other interventions that can be undertaken to address market failures in exploiting the opportunities from multinational include the creation of databases that help minimize search costs for local suppliers looking for opportunities with foreign firms, and foreign firms looking for local suppliers. It is recommended that SMEDA should build a database of SMEs which would include contact details, a listing of goods and services offered, matchmaking services etc. This could be linked with the SME Portal detailed in Section 12. Coordination between suppliers can also be promoted through such databases that allow suppliers to come together to meet large orders and share risk.

5.6. RECOMMENDATIONS

- It is recommended that TDAP organize and facilitate the participation of small firms in international fairs and exhibitions on subsidized rates. There shall be an SME quota, particularly for women, in all trade delegations supported by TDAP. TDAP shall specifically target SME clusters such as in Baluchistan, KPK and GB. Private sector firms can be hired for organizing, marketing and exhibiting products at international trade fairs. The source of financing for SMEs in international trade fairs can come from the BDSF.
- For improving local market access of small businesses and cottage industries in remote areas, there shall be regular trade fairs and exhibitions in all the major cities of Pakistan. These trade fairs and exhibitions can be organized by AHAN in partnership with the provincial industry departments or SMEDA.
- There need to be permanent emporiums established in major cities to exhibit the arts, crafts and cuisine of all provinces and regions of the country. The stalls in these emporia can be rented out on a rotational basis and at a subsidized rate to registered small businesses. SMEDA and AHAN can develop a proposal modelled after the State Emporiums in India and the 'Delhi Haat' which is a cottage industry and food emporium. This proposal can be piloted in either Lahore or Karachi before being replicated in other cities.
- SMEDA can incentivize industry/cluster associations to establish SME sector specific export marketing companies by providing matching grants for conducting international marketing research, developing marketing strategies, developing marketing material, packaging, branding, participating and conducting trade fairs and undertaking promotional and marketing activities. SMEDA can also part-fund design, franchising, licensing, product listing fees etc. to help SMEs expand access to foreign markets. Matching grants can also be provided to sector associations for developing world-class trade and product directories for major SME clusters. The EDF can be used to finance these programs.
- Develop national product standards. These standards shall extend to imported products, especially packaged foods, for which English or Urdu language labels/ingredient lists shall be a requirement.
- In the medium term the role and effectiveness of PSQCA and PCSIR in helping and facilitating SMEs meet international quality standards shall be reviewed.
- Internationally recognized certification institutions/labs shall be set up to facilitate SMEs meet global standards. It is also recommended that SMEDA provide financial support for SMEs to meet the costs of international standards certifications. The BDSF can be used to partially subsidize the costs of certification.
- Implement the e-commerce regulatory framework to incentivize the establishment of 'Online Market Place/Digital Platforms' which would facilitate SMEs in accessing both local and international markets.
- The State Bank shall expedite the approval of applications by local investors to operate payment gateways.

- Incentives such as matching grants shall also be provided by SMEDA to IT start-ups for establishing Online Market Places and Payment gateways which focus on SMEs. SMEDA in partnership with the private sector can also offer trainings to SMEs on the use of 'online market place' or digital platforms and 'payment gateways'
- Investment tax allowances can be considered for SMEs in Pakistan that are suppliers to TNCs or large companies. Expenses that build capacity required by MNCs e.g., licensing, labor training, technology upgradation, improvement in management practices, can be made tax deductible.
- Matching grants for employee training programs can also be extended to SMEs that supply to multinationals.
- Foreign firms or Multinationals in Pakistan shall also be given specific tax incentives tied to local sourcing and to product and Human Resource (HR) development of local suppliers. SMEDA is required to play a strong advocacy role with the Federal Board of Investment to negotiate greater engagement of MNCs with vendor SMEs.

6. PUBLIC PROCUREMENT

Public procurement refers to acquisition or purchase of goods or services by a public sector organization using funds or resources from the public exchequer. Public procurement, because of its spectrum spanning across sectors and domains wherein there is some level of state involvement, is essentially broad in scope and scale. Sizable public procurement can be used as a policy tool from several perspectives: (a) formalization of economic activity, (b) growth and development of SMEs, (c) resolving access to finance issues of SMEs, and (d) support for innovation by small firms.

As public sector is one of the largest buyers of goods and services following a specified set of rules and procedures, it can in comparison to the usually diversified and spread out private sector act as a major client for SMEs. Needless to mention here, SMEs have a significant role in the economy as large majority of organizations fall in this category. Recognizing the potential of roles between the buyer (public sector) and the seller (SMEs in private sector) in the transaction of goods and services, governments have used public procurement to incentivize, support or just help sustain domestic SMEs. Additionally, in the case of developing countries where majority of SMEs are informal entities, the likelihood of winning a government contract or just to be eligible for public procurement can act as a strong incentive to register and formalize – bringing these informal firms into the documented economy.

Before proceeding further on this, it is important to find out how large the share of public procurement to GDP is and how this has evolved over time. Interestingly share of public procurement to GDP is one metric where the numbers in low-income developing countries are comparable to those in high-income developed countries as shown in Figure 8. EU and OECD statistics show that the share of public procurement to GDP is 16 percent and 12 percent respectively. Across regions South Asia has the highest share of 19.3 percent, whereas this number is 19.8 percent for Pakistan (Djankov, 2016).

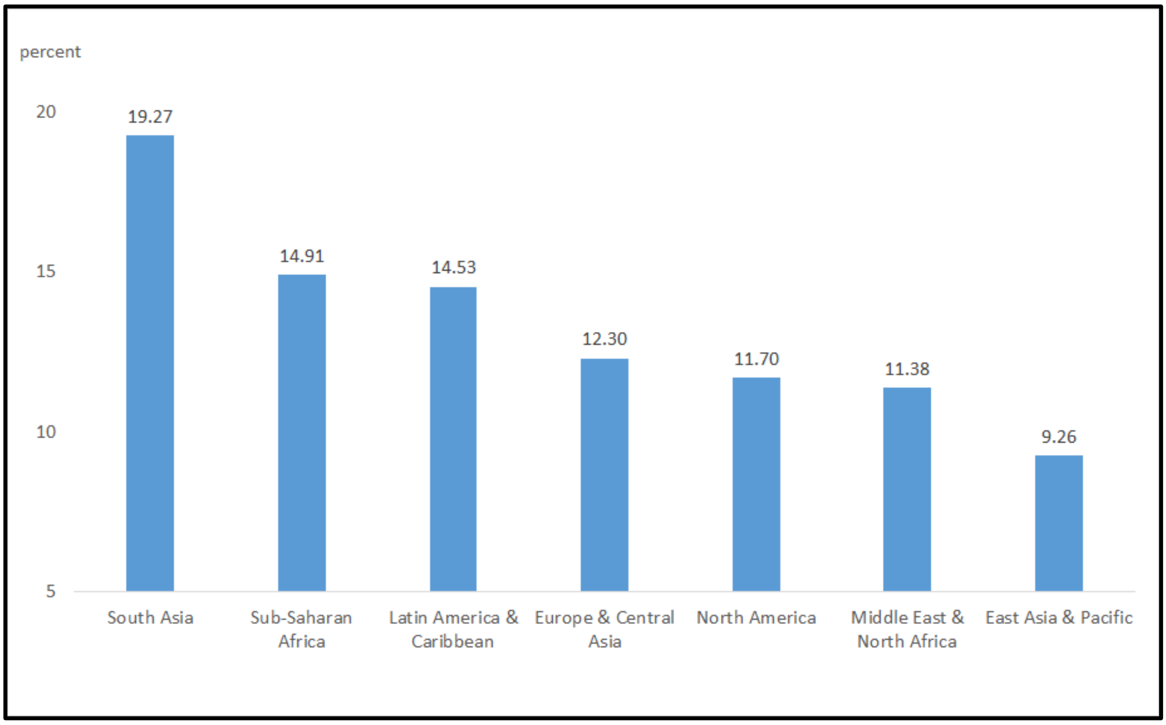

Figure 8: Procurement as percent of GDP by country location

Source: Djankov, Islam & Saliola , 2016.

6.1. Preferential Public Procurement

SMEs face various constraints at different stages of the procurement process. Usually restricted advertisement, narrow pre-qualification criteria, requirement of bid-security deposit, cumbersome documentation, and delayed payments are some of the major hurdles that often hurt the small enterprises.

Realizing the magnitude of public procurement and its potential to deliver on social and economic fronts, many countries have started to use public procurement to strategically support disadvantaged groups within the society. Preferential public procurement entails that necessary goods and services are procured through a process where small enterprises are not hindered by the regulatory barriers to participation in the procurement process. World Bank's 2017 Benchmarking Public Procurement report shows that 47 percent of the 180 national economies analyzed provide some preferential treatment to SMEs in public procurement (Donor Committee for Enterprise Development, 2018).

The United States (US) Federal Government allocates 23 percent of all federal contracts to American SMEs (Kidalov & Snider, 2011). It also has similar reservations for other disadvantaged segments of the society-women, veteran and native American-owned SMEs. In 1994, US Congress amended the Small Business Act to set aside all contracts between USD 2,500 and USD 100,000 (now adjusted to USD 150,000) for awards to SMEs. Similarly, state governments in US also have their own procurement schemes for local SMEs. In recent years, interest has also grown in a number of OECD and EU countries in using public procurement as a tool for fostering innovation and supporting

SMEs. Studying the Australian model of public procurement (Hoekman, 2018) is also interesting as it ensures SME participation for both small and large contracts. Whereas, for the contracts up to one million Australian dollars, it is required that procuring entities obtain at least one quotation from a prequalified SME, for larger contracts the bidders are required to indicate what share of the supply will come from SMEs.

6.2. Significance Of Public Procurement In SME Policy

The motivation for using preferential public procurement is based on a number of factors:

- Recent research points to growth and employment generation impact of linking public procurement with SMEs. Using comprehensive data from Brazil, Ferraz, Finan, & Szerman (2015) found that "winning at least one [government] contract in a given quarter increases firm growth by 2.2 percentage points over that quarter, with 93 percent of the new hires coming from either unemployment or the informal sector. These effects also persist well beyond the length of the contracts. Part of this persistence comes from firms participating and winning more future auctions, as well as penetrating other markets."

- Public sector demand may help resolve constraints pertaining to access to finance that typically affect small firms. The fact that a public agency has evaluated credentials of tender-winning firms, might help attract additional finance from private sources for innovative activities. Additionally, against a successful bid, financing might be provided on the pattern of a back to back Letter of Credit.

- Because of their purchasing power, governments can determine the pattern and direction of innovation directly and indirectly. A government order for an innovative product would cover risks and help firms recover their sunk costs. Also, this generates a signal as a lead user, which can also influence the diffusion of innovation in the society.

How the Preferential Procurement System Works?

In case of EU the following broad measures (European Commission, 2016b) have been taken in this regard.

1. **SMEs Bidding Eligibility Enhancement**

Small firms aspiring to bid for public tenders were often systematically excluded from procurement process because the contracting agencies set high annual turnover figures as a threshold. In order to not only encourage SMEs but to improve their eligibility it is proposed that the required annual turnover should normally not be higher than twice the contract value. This measure shall also act as a protective shield for SMEs against the large market players. This is similar to the set-aside mentioned above.

2. Splitting Large Contracts in Smaller Lots

If large size contracts can be divided into smaller portions, this allows for the participation of smaller enterprises. As such under the reform, contracting authorities are encouraged to divide larger contracts into lots. In case they decide not to split contracts into lots, they will have to record reasons for that.

3. Lowering Administrative Burden

The European Single Procurement Document (ESPD) is a self-declaration form that replaces the several different forms used to ensure that bidders fulfill exclusion and selection criteria (that is registration, tax payment and crossing financial threshold). Documentary evidence has to be provided by the successful bidders. The ESPD is considered as a ’business passport ‘for companies participating in the bidding process.

4. Development of e-Portal

Suggested good practices to support SMEs in public procurement include centralized e-procurement portals. Posting tenders, asking for online bidding and announcement of decisions can help improve visibility of procurement process and lower the administrative costs of the SMEs.

6.3. ELIMINATION

SME Policy 2007 and SMEDA

One of the 2007 policy recommendation was as follows:

All public sector procurement may encourage participation of SMEs with certain products/contracts exclusively to be competed amongst the SMEs.

However, the nature of the policy recommendation was purely advisory and no targets or responsibilities were assigned.

Role of SMEDA and Other Agencies

As procurement is usually decentralized within the Federal and Provincial Governments, so the role of SMEDA has to be diverse. It needs to adopt advocacy measures in case of matters where the issue /decision has to be taken by some outside federal or provincial entity. In order to incorporate a preferential procurement system, SMEDA may have to engage with the federal and provincial procurement regulatory authorities. There are areas in which the preferential scheme might conflict with the existing rules (for example splitting the contracts) and these need to be resolved.

However, SMEDA has to do some inhouse ground work, particularly it needs to be actively involved in development of SME database as detailed in the recommendations section.

6.4. Policy Recommendations

1. The existing public procurement rules have certain inherent biases against the small and medium enterprises. Such systemic hurdles impede the possibility of SMEs competing in public procurement processes. Necessary review and amendments required in the procurement rules are mentioned below.
   i. The possibility of contract bundling vs splitting is important as the flexibility in the size of contract is crucial for SME participation. The existing procurement rules do not favor splitting large contracts into smaller parts and hence limit the participation of SMEs.
   ii. The requirement of performance guarantees bid bonds and securities under the procurement rules to ensure contract enforcement adversely affects SMEs due to their financial constraints.
   iii. The pre-qualification requirements, turnover restrictions (granting higher numbers for large turnover) are again some provisions of public procurement rules that bias the system against SMEs and need to be reviewed and modified.

2. In order to remove information asymmetries, an electronic database of SMEs is required so that it can provide information on their profiles, transactions and geographical locations. This database could be similar to PRO-Net of USA and Electronic Procurement System (ELPRO) of EU and shall provide information about SMEs to the public organizations so that they can be duly evaluated.
3. The policy of reserving at least 10 percent all procurement from SMEs shall be ensured. Given the current size of GDP and extent of public procurement this will result in annual public procurement from SMEs to the tune of 6 billion USD.
4. In instances where the scale of an order is too large for a single enterprise to manage, SMEDA may help a group of SMEs to build a consortium and jointly file a bid to overcome the size limitation.
5. In order to help SMEs cope with their capacity issues, it is proposed that a support unit be established at SMEDA with the mandate to
   I. provide assistance in completing bid documents, obtaining financing, and technical assistance in complex technological bids.
   II. maintain liaison with the government.
   III. provide legal and technical support in case of bid rejection etc.
6. To ensure transparency and to lower the administrative cost of SMEs, it is required that all public procurement be made through a centralized electronic portal. An existing example of such portal is the one developed by Punjab Procurement Regulatory Authority (PPRA).
7. In order to ensure immediate opening up of opportunities for SMEs and to ensure that SMEs get some share from large contracts where they can participate directly, following the Australian model of public procurement (Hoekman, 2018) it is recommended that:

I. Public Procuring agencies must take reasonable steps to obtain at least one written quotation from a prequalified SME supplier for contracts below PKR 10 million.
II. For contracts above PKR 10 million range, bidders must submit industry participation plans that specify how they will provide full, fair, and reasonable opportunities for local SMEs participate in projects.

8. The public procurement support to SMEs can be helpful in overcoming the access to finance issue also. A successful bid information may be shared with a financing agency to help SMEs in overcoming their credit constraints. The review of technical and financial information by a government agency and an order based on that can help in the risk assessment done by private banks. This is somewhat a domestic version of the back-to-back letter of credit method successfully used in Bangladesh.

6.5. MONITORING AND EVALUATION

The policy recommendations presented in this section can be broadly categorized as (a) revision of public procurement rules and procedures, (b) development of SME database, (c) development of e-portal for public procurement and (d) assigning a target of public procurements to be made from SMEs. To monitor the progress on policy implementation the following indicators can be employed:

i. Development of SME database and its population coverage sectorally and geographically
ii. Percentage of public procurements made from SMEs in the financial year
iii. Use of electronic portal for advertising and processing of procurements.

7. BUSINESS DEVELOPMENT SERVICES

Business Development Services, also known as Non-Financial Services, refer to a wide range of services aimed at skills transfer or business advice. These include training, consultancy and advisory services, marketing assistance, information, technology development and transfer and business linkage promotion (Committee of Donor Agencies for Small Enterprise Development, 2001). Table 6 lists some main categories of BDS.

Table 6: Main types of BDS

Categories of BDS		
1. Market access	Market research Market information Trade fairs Product exhibitions	Advertising Packaging Marketing trips and meeting Subcontracting and outsourcing, etc.
2. Infrastructure	Storage and warehousing Transport and delivery Business incubators Telecommunications	Internet access Computer access Secretarial services, etc.
3. Policy and advocacy	Training in policy advocacy Analysis of policy constraints and opportunities	Direct advocacy on behalf of MSMEs Sponsorship of conferences Policy studies, etc.
4. Input supply	Linking MSMEs to input suppliers Improving suppliers' capacity to deliver quality inputs	Facilitating establishment of bulk buying groups Information on input supply sources, etc.
5. Training and technical assistance	Mentoring Feasibility studies Business plans Franchising Management training	Counseling / advisory services Legal services Financial and tax advice Accountancy and bookkeeping Technical training, etc.
6. Technology and product development	Technology transfer / commercialization Linking MSMEs and technology suppliers	Facilitating technology procurement Quality assurance programs Design services, etc.
7. Alternative financing mechanisms	Factoring companies providing capital for confirmed orders Equity financing	Facilitating supplier credit Equipment leasing and rental, etc.

Source: Pinto, R., & UNDP, 2015

Consultations across Pakistan indicated that SMEs in general and small firms in particular identify gaps in the provision of these services. In the surveys that were conducted during the field research, a distinction was made between "operational" and "strategic" business services, where operational services refer to those that are required for the standard running of the firm (e.g. accounts and tax, compliances and regulations, information and communications) and strategic refers to those services that enhance medium to long-term performance (e.g. market identification, product design, seeking finance). Out of the 154 respondents of the field work survey, nearly 120 placed access to markets in the top three required services, and 85 each placed business development and business linkage development in the top three. Other important missing required services were ICT and technology development, accessing finance and marketing assistance.[16] This is illustrated in Figures 9 and 10.

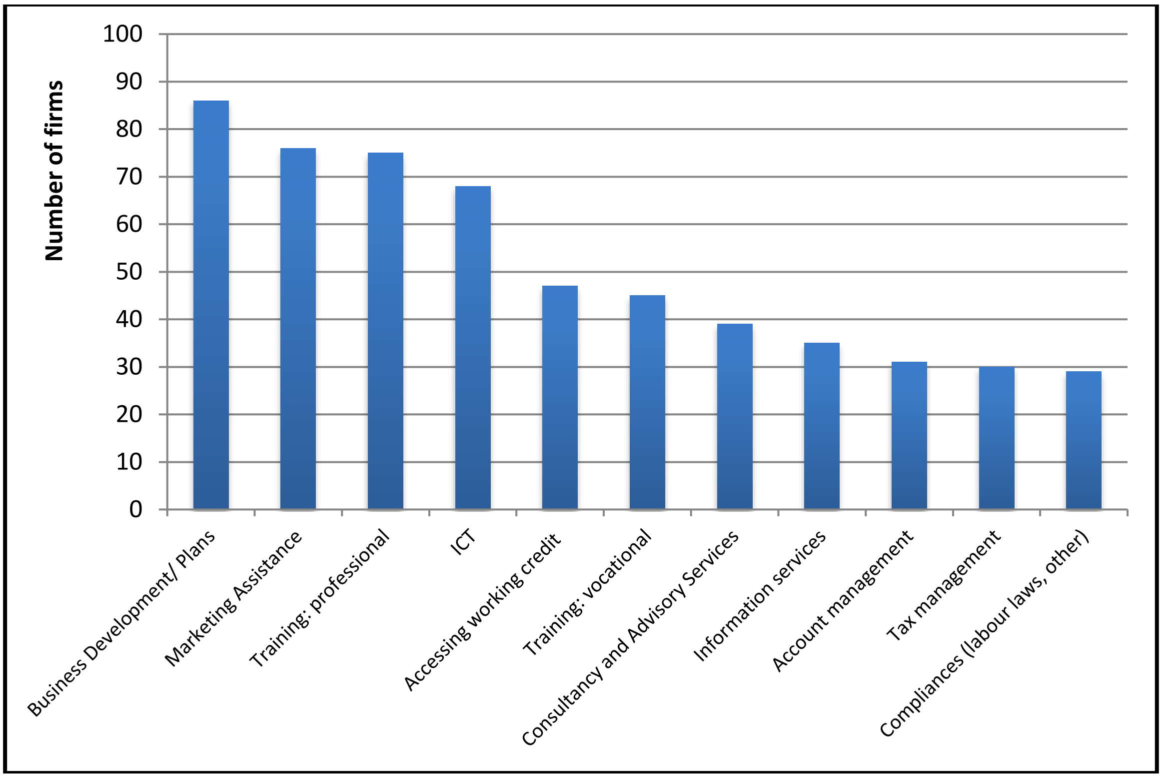

Figure 9: Required operational Business Development Services reported in the fieldwork survey

16 Additional details are available in Deliverable 2: Field Report

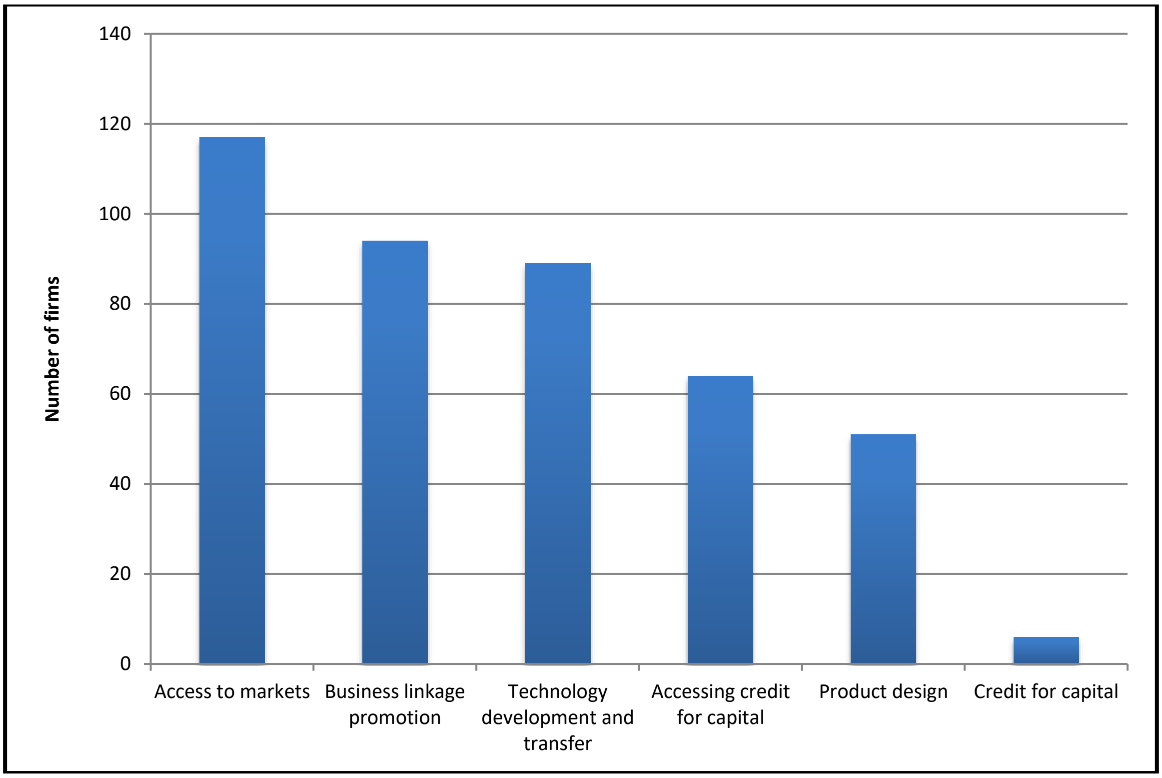

Figure 10: Required Strategic Business Development Services reported in the fieldwork survey

BDS can assist such firms in these areas. The questions for SME Policy are: Should BDS be provided or facilitated by the government? If yes, what kind of services? What kind of firms? What kind of support?

In this section, an evidence-based process is followed for answering these questions. Firstly, evaluations of BDS are analyzed to see if they improve firm performance, with resultant benefits that exceed the costs of delivering these services. A second strand of inquiry is to explore why, if the net benefits are positive, firms do not take up these services as part of their natural profit maximizing decision-making. If there are market and coordination failures that impede this, there is scope for government-funded facilitation. Thirdly, if the answers to both questions are positive, a third line of inquiry is to identify which firms benefit most and the extent to which facilitation is warranted in order to ensure an efficient use of public resources.

7.1. Evaluations Of Business Development Services

While BDS are offered by a variety of institutions, including donor agencies, there are significant issues in evaluating them, which limits the evidence available for policy making. For example, entrepreneurs are typically selected into BDS service/training programs, which makes it difficult to separate the impact of the program from that of the selection criteria. For example, firms that are better informed, motivated and connected are more likely to apply for such services/trainings. And firms that are considered better quality are more likely to be selected for the services, and are more likely to complete the trainings. The final subset of firms that actually complete the trainings or receive the service is therefore likely to have significantly different characteristics *to begin with* from the general population of firms, and it is not possible to use observational data to separate the impact of being more entrepreneurial, motivated and informed, from the impact of the BDS.

Earlier research has found some weak support for modest returns to traditional training programs, as summarized in McKenzie and Woodruff (2013). However, in a recent review of the factors that impact the growth of SMEs, which include training programs, Woodruff (2018) discuss stronger and more nuanced results on specific aspects of training. They are able to tap in to research that uses new techniques such as regression discontinuity and Randomized Control Trials, which address the selection biases that have plagued earlier evaluations.

Firstly, they find stronger evidence on individualized consulting to larger firms, with greater benefits from more customized training/services. For example, Valdivia (2012) finds positive impacts of intensive follow-up sessions with tailored specific technical assistance on revenue and improvements in business practices in Peru. This personalized assistance costs twice as much as basic training. Similar positive results are found by Bruhn, Karlan, and Schoar (2012) in Mexico and Bloom, Eifert, Mahajan, McKenzie, and Roberts (2013) for large textile firms in India.

There is also evidence for the benefits of networking programs on the growth of SMEs, for example in three African countries (Fafchamps & Quinn, 2016) and in China (Cai & Szeidl, 2017). Cai and Szeidl (2017) find that this is through the sharing of information on trading partners and learning better management practices from each other, although for certain kinds of information, learning does not flow between direct competitors. They suggest that optimal networking and mentoring relationships are formed when enterprises share characteristics such as suppliers, production techniques etc., but are not direct competitors.

Another set of interventions that find success in empirical evaluations are incubators and accelerators, which offer services in addition to networking. These can include infrastructure, which is particularly important in countries such as Pakistan with poor business environments. Accelerators can also offer intensive support for a limited period of time to enhance growth in participating young firms. Mentoring and networking are important components of accelerators, reported as the most important component in some surveys (for example, those reported in Roberts, Davidson, Edens, & Lall (2017)). This is sometimes combined with grants and free office space. Gonzalez-Uribe and Leatherbee (2017) find that participants in start-up accelerators had a greater chance of being able to raise finance subsequently. However, Gonzalez-Uribe and Leatherbee (2017) find that the basic package of office space, capital grant and complementary services did not contribute significantly beyond access to finance. An important add-on that did have additional impact, however, was entrepreneurship school, which raised the performance of participating firms significantly. Roberts et al. (2017) find that in their sample of 42 accelerators in six emerging markets, participating ventures in the entrepreneurship school had higher growth in both revenue and employment, and greater increases in capital.

To summarize, there is little evidence of the impact of traditional training programs, and the evidence that is available points to modest returns. There are more significant impacts, however, of customized, intensive training and services, of networking and mentorship programs, and of accelerators and incubators.

There have also been evaluations of approaches to BDS delivery. The traditional approach has been to intervene at the level of BDS transactions, creating an organization that directly provides BDS to SMEs. This approach also usually involves public subsidies to enable SMEs to access the service at a minimal or no cost. Evaluations of this approach have found that it can lead to crowding out of existing and potential new BDS providers. In addition, since the traditional approach is supply driven, outreach and financial sustainability are both low.

In contrast, the market development approach facilitates the development of private sector supply and demand for BDS. While demand may be stimulated initially by subsidized services, these subsidies are temporary and are typically for activities such as provision of information, market research, product development, training of suppliers, and monitoring and evaluations. Transaction-level subsidies are considered distortionary, and a preference is given to pre-delivery BDS activities (e.g. capacity building, raising awareness and providing information, market testing) and post-delivery activities (e.g. feedback and monitoring and evaluation). This is a new approach, and there is insufficient evidence to establish effectiveness conclusively, early evidence points to greater effectiveness (Pinto & UNDP, 2015). In Pakistan, Punjab Skills Development Fund (PSDF) has successfully taken this approach for the development of a private sector market for the provision of vocational skills. Training service providers are selected through a competitive process, and are given part funding. PSDF works closely with employers. In some programs, employers are expected to contribute in kind, providing equipment, physical space, and assisting with curriculum design and training. In return, PSDF provides partial financial support, including stipends for trainees. PSDF does not itself provide any training itself. The result of this is that 90 percent of PSDF's training partners are in the private sector.[17]

This is a useful model, with a proven track record, for SMEDA to follow in developing the market for business development services. An independent Section 42 company under SMEDA, the Business Development Services Fund (BDSF), has been recommended in the institutional section. BDSF can provide part funding for business development services that are chosen by the businesses themselves. Businesses pay the rest for the BDS that they have selected. This ensures that the services taken are market driven. In addition, Business Development Service Provider (BDSP) and SMEDA can provide support in designing relevant services/trainings. For example, to support financial inclusion, SMEDA and BDSF can work with financial institutions and SMEs to design services/trainings that meet the gaps that impede SMEs from accessing financial services.

Some schemes of this nature have been misused in the past, where SMEs create "ghost" BDSPs in order to access the funds without taking any training/service. This can be minimized by restricting funding to BDSPs that are registered with SMEDA, and for services that are booked through SMEDA. SMEDA has the additional responsibility of

[17] https://www.psdf.org.pk/about-us/our-company/

auditing and vetting registered BDSPs, ensuing that they are genuine. A ranking and feedback system, described in Section 7.2 below, will also help with filtering out “ghost” BDSPs.

7.2. Market Failures

Several studies report that even though there are net private benefits for business development services for firms, these services are not taken up spontaneously in the private sector (Karlan & Valdivia, 2011; Bloom et al., 2013). This is an indication that there may be market failures that prevent an efficient level of take-up of BDS, which makes a case for government intervention.

Market failures can arise due to positive spillovers from BDS e.g. the benefits from training accrue to individuals and firms that do not directly receive the training, and therefore the training is underutilized relative to its net social benefits. However, while this logic certainly applies to labor training, where there are positive spillovers as workers move between firms, the benefits of training for entrepreneurs and other firm-specific services are generally considered to be largely private.

Alternatively, there may be information failures such as insufficient knowledge of modern business practices and technologies, and their impact on productivity. There is stronger evidence for this. For example, Karlan and Valdivia (2011) and Bloom et al. (2013) find that entrepreneurs are not well informed about the value of the management practices, not realizing how much better their firm could be run. There is also a substantial literature on network effects in the adoption of new technologies, for example Afraz (2007), Bandiera and Rasul (2006), Conley and Udry (2010), Foster and Rosenzweig (1995), and Munshi (2004), which shows the importance on information spillovers in network externalities to technology adoption. In the presence of such spillovers, there are benefits to subsidizing and/ or facilitating early adopters, which can then pave the way for private provision, with early adopters acting as market leaders.

Apart from information constraints, credit constraints may also affect the ability of the firm to pay for services that they know would be profitable. However even though there is substantial evidence on credit constraints among SMEs, it is less evident that this is the reason for low take-up (McKenzie & Woodruff, 2013). Finally, there are coordination issues. Without sufficient demand, private business development services are unlikely to be offered. But without sufficient good quality providers, there is no way for interested firms to procure services.

In summary, market failures related to insufficient information find the strongest support for government intervention in facilitating and subsidizing otherwise profitable training and support services for SMEs.

There are several actions that can be undertaken to address these information asymmetries. Firstly, an information dissemination role can be undertaken, both to inform SMEs of the options available and to inform BDSPs about the pockets of demand available. SMEDA can undertake this through the SME Portal proposed in the chapter on institutional arrangements. Secondly, a booking, ranking and review system, similar to booking.com, can be hosted by SMEDA. This allows SMEs to book services through SMEDA, and review the BDSP on completion of the service/training. Only SMEs that have booked through the SMEDA portal can provide their feedback, ensuring that the system collates only genuine feedback. Systems such as these have allowed trust and reputation to develop via information sharing for services as wide ranging as hotels, ride hailing and restaurants.

Thirdly, SMEDA can initiate a BDS Needs Assessment, to provide an initial comprehensive set of information to help BDSPs, and to allow a baseline against which to evaluate initiatives. This should cover at least the aspects listed in Table 7.

Table 7: BDS Needs Assessment
1. Demand
• Profile: what types of MSMEs are using which services? Which types of services are not being used? • Benefits: what king of benefits are MSMEs looking for from BDS services? • Awareness: how aware are MSMEs about services? Do they understand the benefits of services?
2. Transactions
• Market: How big is the market? What percentage of MSMEs have tried particular services? • Purpose: Why do / don't MSMEs use the services? • Delivery: How are services delivered? How do MSMEs want them to be delivered? • Features: What service features do MSMEs want? How satisfied are they with what is available? • Prices: What prices are MSMEs paying for services? • Nature: What percentage of MSMEs acquire services through fee -for-service transactions, services embedded in other commercial transactions and for free?
3. Supply
• Suppliers: what kind of suppliers exist? • Products: what range of products is available? • Strengths & weaknesses: what are the strengths and weaknesses of the current suppliers? • Substitutes: what kind of substitutes for BDS do MSMEs use?

Source: Pinto, R., & UNDP, 2015

7.3. Analysis Of Recommendations From SME Policy 2007

The SME Policy 2007 recognized that the private sector market for BDS is underdeveloped, both because of inadequate capacity of existing BDS providers, and because of insufficient demand amongst SMEs, stemming from lack of awareness or capacity to pay.

It was recommended that Government establishes *'Islands of Excellence'* in Human Resource Department (HRD), technology up-gradation and marketing, with participation from SME associations and private sector business service providers. These *'Islands of Excellence'* were to serve as models for replication. In addition, strong incentives to both BDSPs and SMEs were suggested to take up BDS. These included:

- *“Need Assessment Survey to identify major SME needs in HRD, technology up-gradation and marketing.*

- *Establishment of Institutes of Small and Medium Enterprise & Entrepreneurship Development (INSMED) in select business schools.*

- *Capacity building and up-gradation (curriculum redesign, provision of equipment, teachers training, SME liaison, etc.) of selected sector specific technical training institutes serving in major SME clusters and establishment of such institutes where none exist.*

- *Encouraging use of the technical training infrastructure by the private sector Business Development Service Providers (BDSPs) serving SME sector and incentives for investment in setting up SME training facilities.*

- *Induction of genuine SME representatives in private sector boards of the technical training institute.*

- *Establishment of Technology Innovation Centers (TICs) offering common facility, technology up-gradation, R&D and design related services to SMEs.*

- *Establishment of technology and business incubators in selected universities in Pakistan.”* (SMEDA, 2007)

These recommendations are still valid. The recommendations in Section 6.5 extend these by simplifying the mechanism for supporting the market till it develops. The focus is now on matching grants to SMEs to acquire BDS. In this way it operates like a voucher system that has a greater capacity to transmit market-based signals, rather than crowding out private provision. In addition, the recommendations formalize a system for improving the exchange of information. This addresses the central market failure of insufficient information on the benefits of a service and on the quality of BDSP. This also puts pressure of performance on the BDSPs, while supporting them by enhancing the demand for their services through the price subsidy. For BDSPs, it also provides a source of information on the location and nature of firms, and the services that are required. Therefore, these are *market-making* interventions with a view to ease government exit as the market develops. The recommendations reduce the decision-making required of the state (determining what kind of BDS providers to support, what kind of curricula development etc.), keeping subsidies broad-based, and allowing and supporting the private sector to take the lead in determining the details.

7.4. RECOMMENDATIONS

1. The model for BDS shall be to facilitate private provision of BDS services rather than government/donor provision.

a. This should start with a BDS market assessment, which identifies specific market development constraints that are to be addressed (e.g. reasons behind the lack of demand and/or supply of services, extent of market distortions, willingness of pay). This also includes an assessment of available local institutions and networks, and provides a baseline that can be used to evaluate progress

b. Matching grants can be offered to SMEs for the BDS services that they take with BDSPs that are registered with and booked through SMEDA. These are time limited. These grants should be evaluated every five years to allow course correction, with the aim of tapering off gradually over the next 10 years. A clear exit strategy should be in place from the outset.

c. Part-funding a fixed proportion of the costs of the service will naturally mean a greater state contribution towards those services that offer the more beneficial customized, intensive assistance, as these are costlier.

d. In addition, an online rating system for service providers shall be widely advertised and made available publicly to address information asymmetries (similar to the rating models for restaurants, hotels and ride hailing services such as booking.com and foursquare.com). SMEDA can host this online forum as part of the SME Portal described in Section 12.

e. SMEDA shall play a facilitation and coordination role in informing firms of the availability of services and rankings, and by providing BDS providers information about required services. The online portal can assist with this by providing a way for firms to signal their requirements to potential BDS providers, and for firms to be able to find suitable BDS providers, and for firms to coordinate and group together for customized joint training sessions. SMEDA can host this online forum as part of the SME Portal described in Section 12. SMEDA can also provide technical support and coordination in designing appropriate BDS.

f. A larger portion of the costs shall be shared for women-led SMEs and for new-firms.

g. Infrastructure sharing with public sector training providers shall be supported and encouraged.

7.5. MONITORING AND EVALUATION

Data collection and evaluation should be built into the models suggested above, so that they can be evaluated regularly and scaled up or shut down as required. This includes an evaluation of the National Incubation Centre programs.

Monitoring and Evaluation can use the Donor Committee's Performance Measurement Framework for BDS (CDASED, 2001; Reichert, Lempelius, & Tomecko, 2000). The table below lists the indicators.

Table 8: Monitoring and Evaluation

Indicators of Donor Committee's Performance Measurement Framework for BDS	
Market size: Number of SMEs purchasing the service	SMEs fully paying for the service
	SMEs paying fees for service
	Total no. of training participants
Market size (supply): amount of sales by BDS providers	Providers- sales to SMEs (participation fees)
	Providers- sales total (incl. institutional clients)
Market penetration	percentage of potential SME market reached with a BDS
Number of BDS providers	Providers with similar products
Number of BDS service types	Number of BDS products promoted
Well distributed, wide price range for BDS	Price range: participants fees
	Price range: total price incl. payments by institutional clients
Average price per unit of BDS	Average price paid by SME (participants fee) per training day
	Average total price (incl. payments by institutional clients) per training day per participant
Multiple users	Number and proportion of multiple user customers
Market distortion	Average total subsidy content in percentage
Deepen the market: reach underserved groups	Female clients in percentage
	Small and new firms (as per proposed definition) in percentage
	Ethnic minority clients in percentage
	percentage of potential target market reached

Table 8: Monitoring and Evaluation	
Achieve supplier sustainability	BDS supplier cost recovery of operational cost from client's fees
	BDS supplier cost recovery from individual and institutional clients excl. project subsidies
Improve program cost effectiveness	Simplified cost-benefit assessment (total program cost/ year: aggregate program benefits for entrepreneurs/ year)
	Total program cost
	Total program cost per customer served
	Total program cost per supplier assisted
	Total program cost per $1 increase in supplier revenue
Increase customer acquisition of BDS	Customer satisfaction with a BDS
	Repeat customers
Increase customer use of BDS	percentage of customers who improve business practices as defined by the supplier
	Increase in employment
	Change in investment
Increase customer benefits from BDS	Change in value added (sales - raw materials)
	Increase in sales
	Increase in profitability

Adapted from: Reichert, C., Lempelius, C., & Tomecko, J. (2000, April)

8. ENTREPRENEURSHIP

A facilitative entrepreneurship ecosystem is important, as entrepreneurs lead to business creation, generating innovative solutions to problems and creating technology. In turn this leads to higher quality and quantity of jobs.

Entrepreneurs are distinguished from small business owners ("necessity" or "subsistence" entrepreneurs) in the sense that there is an element of fresh thinking and vision in entrepreneurs, which leads to innovations or commercialization of innovations. This excludes the many self-employed individuals that sell basic items on street corners. These small businesses typically arise from a lack of jobs rather than a novel idea, e.g. the *theley walas* and *parchoon* shops of Pakistan. These necessity entrepreneurs make a valuable contribution to poverty reduction for themselves and their families, and in some cases one or two employees, but do not have the economy wide impact of entrepreneurs (Olafsen, & Cook, 2016). The justification for government support for these necessity entrepreneurs is weak, both on the grounds of market failures and on the grounds of spillovers. Entrepreneurs, on the other hand, bring important knowledge spillovers to the economy, and have in addition demonstration effects of proving the viability of new technologies. They also have a greater scope for scaling up into large businesses, and therefore contributing substantially to employment.

This section focuses, therefore, on innovative entrepreneurs ("opportunity" or "transformational" entrepreneurs), using the Global Entrepreneurship and Development Institute's (GEDI) definition of entrepreneurship as *"the dynamic, institutionally embedded interaction between entrepreneurial attitudes, entrepreneurial abilities, and entrepreneurial aspirations by individuals, which drives the allocation of resources through the creation and operation of new ventures"* (Acs, Szerb, & Lloyd, 2018)

A supportive entrepreneurship ecosystem can encourage individuals to become entrepreneurs, to get a second chance if they fail, and can support start-ups to scale up into larger businesses. The ecosystem comprises conducive policies, labor markets including capital, culture and support mechanisms. The Global Entrepreneurship Index measures the quality of entrepreneurship and the extent and depth of the supporting entrepreneurial ecosystem, providing a mechanism for benchmarking countries and progress over time. Pakistan is ranked 120th out of 137 countries on this index. While the low ranking comes from low scores on all 14 pillars, the scores on the institutional variables are much lower (31 percent) than the scores on individual variables (48 percent). As illustrated in Figure 11, risk acceptance, risk capital and start-up skills are the weakest areas in Pakistan.

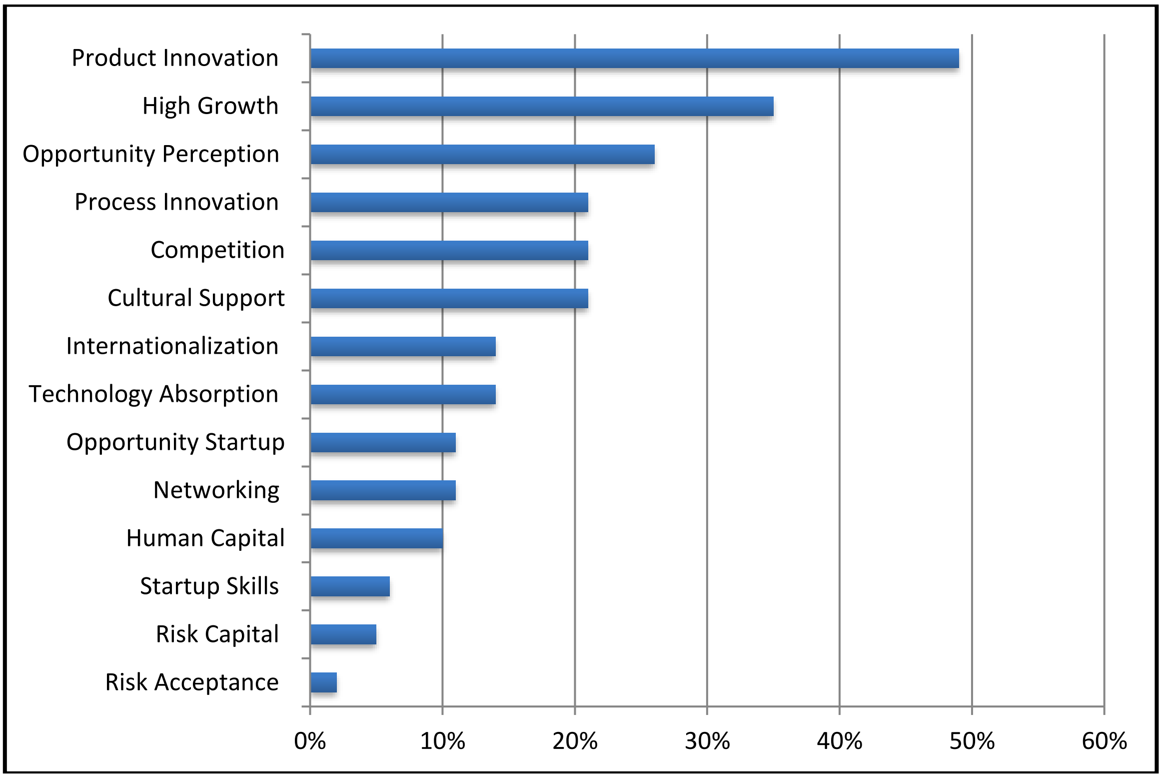

Figure 11: Entrepreneurship index component score for Pakistan

Source: Acs et al., 2018

8.1. Risk Capital

Risk capital i.e. the availability of risk finance such as equity (as opposed to debt) is critical for entrepreneurs. There are several obstacles in raising risk capital in Pakistan.[18] Firstly, in order to raise risk capital, firms are required to register formally with SECP. This form of corporatization is too administration heavy for start-ups, placing reporting requirements on them that require accountants and lawyers before they are even profitable. One solution for this is to introduce a more informal form of registration that allows limited liability partners to participate by providing equity, yet remain limited in liability to the finance that they provide. General partners can retain unlimited liability. The Limited Liability Partnership Act 2017 has been adopted by the Federal Government and is an important step in the right direction. However, since partnerships are now in the provincial domain, it requires the provinces to recognize this more flexible form of partnership (Afraz, Khawar, Naqvi, Javaid, & Bakhtiar, 2018).

An important impediment to risk capital is the SECP rules for registering a venture capital company, which makes it virtually impossible to register a venture capital

[18] The discussion of Pakistan specific risk-factors is based on stakeholder interviews, including an interview with Faisal Sherjan, Director Operations, at the National Incubation Centre, Lahore.

company in Pakistan. They are treated under the “Non-Financial Institution” category, the rules of which are not appropriate to the business model of venture capitalists. The result of this is that venture capital companies register offshore rather than in Pakistan, with consequent disadvantages for an unobstructed movement of capital. Half of the 45 start-ups surveyed for the Jazz Digital Entrepreneurship Ecosystem Report 2017 applied for foreign venture capital funds. Since funding of more than USD 100,000 requires start-ups to register abroad, there is a disincentive for them to stay in Pakistan (Jazz, 2017). Furthermore, angel investors are required to justify the premium that they pay for shares in start-ups, which adds another layer of difficulty to raising risk finance.

Another important source of risk capital is individual savings. There are several interesting models that channel individual savings towards start-ups. In the UK for example, Individual Savings Accounts (ISAs) with an annual limit of GBP 20,000 can be invested in stocks and shares, with a Great British Pound (GBP) 2000 tax-free dividend allowance, and no capital gains tax to be paid on increases in the value of the stocks and shares. This creates an attractive pool of equity finance for start-ups.

Crowd funding, which is currently not allowed under SECP rules, is another useful untapped source of risk capital. Successful examples of countries with crowd funding rules include Canada, where an appropriate regulatory framework has allowed real estate development to be largely crowd-funded. In the UK as well, equity crowd funding, where individuals, even with small pockets of savings (as opposed to only very wealthy individuals, venture capitalists and business angels) can invest in an early-stage unlisted company in exchange for shares in that company, with heavy tax advantages. The Enterprise Investment Scheme and Seed Enterprise Investment Schemes offer 30 and 50 percent income tax relief to investors. There are several successful models of platforms that can be replicated for crowd funding, such as SEEDRS in the UK, which has helped raise GBP 395 million for 585 companies in the UK and Europe. Similarly, FundedByMe in Sweden offers both reward-based and equity crowd-funding, linking 93,000 investors from 197 countries with 463 companies in 25 different countries by 2017 (Trajkovska, 2017).

Patient capital is another appropriate funding option that allows for a longer horizon for recovery, typically for “impact investment” that has social objectives in addition to financial objectives. The supply of patient capital can be enhanced by specific seed funding, such as in the UK’s British Patient Capital (BPC), a subsidiary of the British Business Bank, which was given GBP 2.5 million to enable long-term investment in high-growth innovative companies. Its approach is to increase the volume, diversity and accessibility specifically of long-term finance for SMEs (HM Treasury, 2018). In addition, appropriate and enabling legal frameworks are also required, such as those that enable pension funds to invest in patient capital.

Incubators and accelerators can also provide start-ups with access to investors. National Incubation Centre in Pakistan, for example, helps start-ups not just with business skills, but also with developing their business idea, and pitching it to investors. In addition, it hosts sessions where investors are invited to hear the ideas and fund them. This model can be evaluated and scaled up. It can also be supported by providing favorable tax arrangements to investors to channel their savings to such centers (instead for example in real estate speculation).

In general, whether through incubators or otherwise, tax benefits for venture capital and business angel investors can facilitate their provision and help compensate for the inherent riskiness. This includes upfront tax relief on capital gains and loss relief on more favorable terms that the baseline tax system. The United Kingdom's Seed Enterprise Investment Scheme (SEIS), a top ranked tax incentive scheme for venture capital and business angel investment, for example, provides an upfront tax credit to individuals making investments in young companies. It also provides for a capital gains tax deferral for reinvestment, capital gains tax exemption for chargeable gains realized on disposal, and for loss relief on favorable terms for capital losses. There is a maximum investment value that qualifies for tax relief, and a minimum holding period (European Commission, 2017).

8.2. Innovation Friendly Regulations

Apart from the standard ease of doing business regulatory issues discussed, there are other specific regulatory problems that can impede entrepreneurship. The World Economic Forum has surveyed over 1,000 entrepreneurs across the world to understand the experiences of successful entrepreneurs in growing scalable, high growth firms. The survey included questions on government policy/regulatory environment aspects that were most beneficial or most detrimental in their growth journey (Foster et al., 2013).

Figure 12 presents a word cloud for the top 40 words used for beneficial policies/regulation. It is evident that taxation and regulation are the most frequent themes. Similarly, the word cloud for the most impeding aspects puts up Tax as by far the most important impediment.

Figure 12: Word cloud for government/ regulatory policies as an early-stage company growth accelerator

Source: Foster et al., 2013

Taxation

In Pakistan, the taxation regime acts as a severe obstacle to start-ups, both because of high tax rates (discussed in detail in section 3.2), and because of a poor understanding of new business models. For example, there is a requirement to pay taxes on the turnover rather than value added for delivery services (currently contested in courts). Punjab Revenue Authority (PRA) rules are particularly distortionary for local start-ups. International firms such as Airbnb and Google can offer services in Pakistan and are not taxed, yet domestic firms that offer similar services pay PRA taxes and therefore struggle to compete.

Procurement

Non-tax regulatory authorities create similar problems. For example, for education start-ups offering novel solutions for cost-effective schooling, the biggest end user is the state. Yet Punjab Procurement Regulatory Authority (PPRA) rules make it virtually impossible for SMEs and start-ups to meet the requirements for procurement. In general, there appears to be a "guilty till proven innocent" attitude towards new business models and new businesses, which limits the space for growth and the creation of new ways of doing business.

This can be addressed by increasing the participation of start-ups in public procurement. The public sector can also take on a stronger role as a lead customer for new technologies.

Regulating New Types of Business

Regulatory sandboxes, which adapt compliance with strict frameworks, have allowed space in other countries for new business models while not diminishing consumer protection. This has been particularly important in the fintech industry, for adapting the otherwise strict financial regulations in the testing phase of a new service. These sandboxes are based on a participatory model with stakeholders, so regulatory agencies can learn about appropriate regulation for new business models as they develop, and allow the innovators to conduct live experiments in a controlled environment, under supervision of the regulator. Regulatory sandboxes have been used in many countries including the Netherlands, Singapore, China, Bahrain, India and Malaysia. The UK's Financial Conduct Authority has won recognition for its successful sandbox, so is one model that can be explored for suitability to Pakistan.

Supportive rules and regulations can also encourage payment gateways, which have so far kept away from Pakistan due to inappropriate and excessive regulation. The lack of payment gateways is an important impediment for e-commerce.

Recruiting Foreign Talent

Another critical aspect is access to foreign talent. As indicated in Table 9, while the supply for a well-educated and suitably skilled local workforce was important for the entrepreneurs surveyed by the World Economic Forum, a visa regime that allowed foreign talent to be recruited was also critical.

Table 9: Human capital/ workforce ecosystem pillar and government/ regulatory policies: survey quotations

Panel A: Growth Accelerators
- "Supply of well-educated workforce" (France, Web-based services) - "Availability of strong technical talent in Monterrey" (Mexico, internet travel) - "Investors available with specific industry knowledge and experience" (Sweden, transport) - "Easy to bring in anyone from anywhere in the world on a visa" (UAE, fashion retail trade) - "Ability to get top-notch accountants and lawyers who will provide services at big discounts for anticipated future relationships" (USA, investments)

-	"Government reimbursement for training in growing organizations" (USA, Web hosting)
Panel B: Growth Inhibitors	
-	"The granting of share options is treated as employee income at the time the option is granted" (Australia, electricity storage)
-	"Immigrations laws are a hurdle to recruiting foreign talent" (Austria, medical devices)
-	"Immigration policies prevent the free movement of qualified people" (UK, financial advisory)
-	"Difficulty in getting work visas (H1-B) for foreign engineers" (USA, utilities)
-	"Visa limitations on allowing foreign talent to stay in the US" (USA, venture capital)
-	"Willingness to tolerate frivolous lawsuits around discrimination — if I hired someone and then fired them six months later how can that be discrimination?" (USA, enterprise software)

Source: Foster et al., 2013

A rigid immigration and visa policy prevents firms from recruiting globally and from attracting foreign entrepreneurs. Countries that recognize the importance of entrepreneurs provide special visas for them. For example, the UK's Tier 1 Entrepreneur visa is for eligible applicants who want to set up a business in the UK and come with access to GBP 50,000 in investment funds. There are two further entrepreneur visa options. Similarly, under Canada's Start-up Visa program for immigrant entrepreneurs, foreign entrepreneurs who have a commitment from a designated business incubator and funding of at least Canadian Dollar (CAD) 75,000 from a designated angel investor group (or CAD 200,000 from a designated venture capital fund) are given visas to set up in Canada (Ernst & Young, 2015). In Chile, Start-up Chile allows selected entrepreneurs around the world to receive USD 40,000 in seed money from the government in addition to a work visa. This has attracted 1,000 entrepreneurs in 4 years. These entrepreneurs are also expected to participate in entrepreneurship awareness (Espinosa, 2015). This measure, amongst others, has allowed Chile to punch above its weight in the sense of having high levels of new businesses and high impact entrepreneurs relative to size of economy (Global Economic Monitor, 2015).

Intellectual Property

Another important regulation that impacts entrepreneurship is intellectual property protection. The biggest asset of a start-up is its idea, and a strong intellectual property regime protects it by making it quick and easy to register property right and enforce rights and conflicts.

Bankruptcy Laws

Bankruptcy laws are also important for entrepreneurs, for whom the ability to get up and start again is critical. There is a natural risk in trying out something that has not been tested in the past, and therefore failure rates are high. Small business owners usually have personal liability for their non-incorporated businesses, which means that business failure has serious personal implications. Strict bankruptcy laws, which are aimed at reducing risk for creditors, can therefore also reduce entrepreneurial activity by increasing risk aversion amongst entrepreneurs. On the flip side, making it easier to default has moral hazard problems. A good bankruptcy law strikes a balance between the competing priorities of protecting creditors and allowing honest start-ups to exit a business and start again. Individuals gaming the system and deliberately defrauding people can be treated as a criminal activity, and separated from genuine business failure.

Making it quicker and easier to close a business is vital for facilitating a fresh start. Many entrepreneurs test several business models, learning each time and increasing their chance of success the next time. Laws that allow firms a chance to restructure their debts before starting liquidation proceedings can help with recovery, and can also help creditors. Legal provisions can allow for the rehabilitation of distressed companies, particularly small and start-up companies, through such creditor arrangements.

For example, Chapter 11 of bankruptcy laws in the US provides three options for firms in financial distress: restructuring, preventative composition (court action to protect creditors' assets at risk from bankruptcy), and declaring bankruptcy. In addition, firms that declare bankruptcy under Chapter 7 have to give up all their assets, but not those assets that are protected under the code, such as personal housing and future earnings and assets. Bankruptcy can also be decriminalizing by reducing employment and credit restrictions on defaulters. Good examples in addition to the US laws include Chile's re-entrepreneur law, which eases bankruptcy proceedings. Similarly, Columbia, another notable success in entrepreneurship, describes the approach to entrepreneurship policy as "try fast, learn fast, fail cheap", an approach that is supported by its legal framework.

Pakistan has approved the Corporate Rehabilitation Act, 2018 in March 2018, which is based loosely on Chapter 11 of Title 11 of the United States (US) Bankruptcy Code. However, SECP has not yet promulgated regulations to support the new law and it remains to be seen how effectively it will be implemented (Afraz et al., 2018).

University Regulations

A better understanding of entrepreneurship is also required in universities, which can leverage their research labs to maximize the commercialization benefits of innovations. Universities such as Stanford and Massachusetts Institute of Technology (MIT), for example, have intellectual property arrangements that allow them to become equity partners in commercial applications of research that origin from their labs. Allowing faculty to commercialize their research is a win-win arrangement for both researchers and the economy.

8.3. INCUBATION AND ACCELERATION

Business incubation is an umbrella term for a variety of support activities. The UK Business Incubation Association defines incubation as "a unique and highly flexible combination of business development processes, infrastructure and people, designed to nurture and grow new and small businesses by supporting them through the early stages of development and change' (UK Business Incubation, 2013). Incubators can include training for entrepreneurs, access to networks and specialist equipment and physical office space. Typically, incubators charge a membership fee or rent rather than taking equity in the start-up, and have an open-ended duration. Incubators can be aligned with universities, and typically receive funding from universities and/or the public sector.

In contrast, accelerators typically follow a highly selective and time-limited service, usually taking in one cohort at a time. The support offered usually includes help with business plans and investor pitch development, prototype development and market testing. The financial model of accelerators is based more on equity than on rent. While the model targets rapidly growing start-ups, corporate accelerators can have other strategic objectives such an internal innovation and corporate social responsibility. Corporate accelerators are also increasingly supporting high growth start-ups in scaling up. In the UK, 51 percent of accelerators receive funding from the corporate sector (Bone, Allen, & Haley 2017). Accelerators are more likely to be funded by the corporate sector, as compared to incubators.

There are several models of successful private sector accelerators in the world. For example, Stock Keeping Unit (SKU) in the US focuses on supporting successful start-ups (i.e. products that have already been developed and tested in the market) into rapidly scalable companies. Mentees are inducted in a single cohort of ten start-ups each year and receive 12 weeks of training including entrepreneurial goals, product concept and market sizing, product development and market validation, packaging and branding, trade and marketing, channel strategy and sales forecasting, finance and accounting and legal. In addition, they have opportunities to network and access to venture capital funds, attorneys and other professionals. The mentees are also matched to mentors. SKU takes an equity interest of 4-8 percent in their start-ups. Other sector specific successful accelerators include Sephora, which assists female-founded entrepreneurs in the beauty industry, and R/ GA which focuses on the digital industry (Greenwald, 2016).

Accelerators allow corporates to solve business problems quickly, and at a lower risk, expand into new markets, and generate creative innovative brands. It is an ideal synergy, as start-ups get access to potential business opportunities with important players in their field. Other benefits to start-ups of linking up with their corporate investor are (Foster et al. (2013):

- Customer engagement: they can act as early customers for start-ups
- Credibility enhancement: through brand displays and references
- Mentorship and advice: especially on new markets and industry structure
- Go-to-market partners: as distributers and/or resellers, and for logistics and warehousing support
- Capacity enhancement: for operating capability
- Licensing leverage: for licensing patented technologies

Another common source of funding is the government. In the UK, for example, 41 percent receive public funding (Bone, Allen, & Haley 2017).

The government has taken some initiatives for incubators already. For example, Ignite (former National ICT Research and Development (R&D) Fund) supports several incubators, and events relevant to start-ups. Funding for academic R&D, and programs for universities to incubate entrepreneurs are also available. There are now sixteen incubators, four accelerators, and at least ten co-working spaces available across Pakistan. Despite this, the numbers of start-ups incubated are low – just 95 start-ups graduated from incubators in 2016 (Jazz, 2017). Successful incubation and accelerator models can be evaluated, and scaled up with extended outreach. This can be done through providing tax incentives to corporates to channel funds into them, and by providing seed money and suitable infrastructure using public funds. Evaluations can also help identify weaknesses that need to be addressed to help improve the effectiveness of incubators and accelerators.

8.4. Education And University Linkages

Start-up skills and an entrepreneurial mindset are critical to launching successful startups. These can be cultivated at school and universities through experiential learning, entrepreneurship training and extracurricular programs. Entrepreneurship can be integrated in primary and secondary schools, and taught as a specialized stream at higher levels. Prioritization of Science, Technology, Engineering and Mathematics (STEM) in schools also helps build a pool of suitably skilled people.

Successful examples include the UK's "The Fiver Challenge" in which 5-11-year-old school children are given GBP 5 to set up their own business. Similarly, the Zhejiang Government (China) established a USD 5.5 million fund in 2011 to help fresh university graduate support start their own business. This fund is used for seed funding as well as subsidized loans. The new businesses that they set up are exempt from all registration and licensing fees for the first three years. Turkey too has a "Lifelong Learning Strategy" with key competencies that explicitly include entrepreneurship. Slovenia has introduced entrepreneurship studies as early as primary school, encouraging students to explore creativity, innovation and entrepreneurship by raising their awareness (Ernst & Young, 2015)

Mentorship programs can also help. For example, the US Government's Entrepreneurial Mentor Corps leverages current entrepreneurs to help build and support the next generation of entrepreneurs.

Universities are important partners and catalysts for encouraging entrepreneurship, not just because they can include entrepreneurship in formal educational programs, but also because research and innovation go hand in hand and generate commercializable ideas. Examples of university research spin-offs include Polyera, which was spun-out of material science research at Northwestern. Polyera's own labs were subsequently set up 10 minutes from the University, and initially Polyera continued to leverage equipment at Northwestern, which helped keep initial costs low. The University also proved to be an important source of talent to recruit. As Polyera grew, they moved to sponsoring research at the University, and consequently benefit from the ideas generated from these programs (Foster et al., 2013). Universities can also engage industry in developing focused trainings for technology and digital sectors, and promote youth mentoring and networking opportunities with industry. Government can assist by providing funding incentives for universities for supporting coaching and mentoring schemes.

8.5. Analysis Of Recommendations From SME Policy 2007

The SME Policy 2007 includes many of the themes discussed above, particularly those related to fostering entrepreneurship culture and mindset in schools and universities. The following recommendations were made.

- *"Establishment of INSMED in select business schools.*
- *Establishment of Technology Innovation Centers (TICs) offering common facility, technology up-gradation, R&D and design related services to SMEs.*
- *Establishment of technology and business incubators in selected universities in Pakistan.*
- *Revision in primary and higher education curricula for promoting entrepreneurship amongst the educated youth.*
- *Inclusion of 'Entrepreneurship' courses in (all professional degree awarding) higher education, technical and vocational training institutions in Pakistan.*
- *Entrepreneurship Competitions at university level to culminate in Annual Entrepreneurship Competition at National level for selecting best business plans/models and providing grant for project implementation.*

- *Establishment of technology and business incubators in selected universities in Pakistan.*
- *Identification of investment opportunities offered by backward and forward linkages of successful services/products"* (SMEDA, 2007).

The new recommendations extend these by offering suggestions for addressing the two major bottlenecks present for entrepreneurs in Pakistan today: the availability of risk capital, and inappropriate regulations. There are also some critical differences between the approach suggested for supporting incubators and accelerators. The new recommendations are geared towards facilitating the private sector in taking a lead on this as far as possible by providing tax and regulatory incentives, rather than the government itself taking the lead in setting up such facilities itself.

8.6. RECOMMENDATIONS

It is critical to address all aspects of an entrepreneurial ecosystem. Incubators, accelerators, investment funds, service providers, leveraging large companies, universities, and the regulatory framework are all complementary, and do not work in isolation. Therefore, a holistic approach is favored over piecemeal interventions. The nature of entrepreneurship is such that Government plays a facilitative role to private actors. The following recommendations arise from the analysis above.

1. Improving expansion of risk capital. In addition to the recommendations contained in Section 9:

    a. Advocate for the adoption of the Limited Liability Partnership Act 2017 by provinces.

    b. Create a legal framework for crowd-funding, and create suitable rules for venture capital funds to register with SECP.

    c. Provide tax benefits to channel individual small savings accounts into equity finance, modeled on the UK's tax benefits for Individual Savings Accounts. E.g. Individual savings up to 2 million PKR can be invested in stocks and shares, with up to PKR 200,000 tax free divided allowance, and no capital gains tax on increases in the value of stocks and shares

    d. FBR will develop a tax regime that encourages the flow of capital from corporates and Venture Capital Companies (VCC) to start-ups and incubation centers and accelerators.

    e. Develop favorable tax arrangements such as tax relief for capital gains tax, or provisions for loss relief, for corporate investors to channel their savings to equity finance e.g. to incubators, accelerators and other venture capital and business angel activity.

2. Regulations:

    a. Taxation:

        i. Lower corporate income tax rates and sales tax, and keep them uniform as far as possible.

   ii. Develop an adaptable and business facilitating approach to taxing new forms of business models.

b. Public Procurement:

   i. Relaxation of Public Procurement Regulatory Authority (PPRA) rules that favour large firms in bidding for government procurement projects.

   ii. Procure technology solutions from local start-ups.

c. Recruiting foreign talent:

   i. Adopt a relaxed immigration and visa policy for entrepreneurs and investors.

d. Intellectual property rights:

   i. Adopt reforms to make it easier and quicker to register intellectual property, and to resolve disputes.

e. Starting again:

   i. Make it quicker, easier and cheaper to close a business including options to restructure debt.

   ii. Ensure effective implementation of the new Corporate Rehabilitation Act, 2018 in March 2018 and ensure SECP promulgates regulations to support the new law.

f. Regulations for new business models:

   i. Adopt a regulatory sandbox approach for monitoring and regulation of new businesses that are still evolving and developing e.g. fintech.

g. Support universities in developing systems to allow commercialization of innovations arising from their labs.

3. Accelerators and incubators:

   a. Provide a favorable environment for private sector corporate accelerators, including tax incentives to corporates to channel funds into them, and by providing seed money and suitable infrastructure using public funds.

   b. Evaluate and scale up initiatives such as the National Incubation Centre.

   c. SMEDA shall initiate an Entrepreneurship boot camp to train youth for accessing the government's youth entrepreneurship loan program. SMEDA shall provide full hand-holding support before selection of successful candidates and post selection guidance on making the business sustainable.

4. Education and University linkages:

   a. Encourage entrepreneurial skills at school with support for developing programs via experiential learning, entrepreneurship training and extracurricular programs e.g. the UK "The Fiver Challenge".

b. Encourage teaching of entrepreneurship as a specialized stream at high school and university.

c. Provide support for seed funding for fresh university graduates wishing to start their own ventures.

8.7. MONITORING AND EVALUATION

The entrepreneurship ecosystem can be monitored using outcome indicators such as

- Number of registered start-ups (baseline 300 in 2016, (Jazz, 2017))
- Number of incubated start-ups (baseline 95 in 2016, (Jazz, 2017))
- Number of incubators, accelerators and co-working spaces (20 incubators in 2017, (Plan9, 2017)).
- Volume of venture capital finance disbursed
- Volume of equity finance investments from individual savings accounts and corporates
- Number of Venture Capital Funds registered onshore
- Number of limited liability partnerships registered

9. CREDIT

Access to affordable finance is a key issue for SMEs; consequently, majority of the SMEs in Pakistan operate through self-financing, informal financial services or retained earnings. This not only limits the scope of expansion, but hinders day to day business by limiting working capital available to the firms. The results of sample surveys done by the Asian Development Bank suggest that in Pakistan only about 6 percent of fixed investment finance for SMEs comes from development finance institutions and commercial banks (Bari, Cheema, & Ul-Haq, 2005). The stakeholder consultations and focus groups conducted for the development of the SME Policy exercise had similar findings. Most businesses reported that their start-up investment is self-financed, while continuing operations of the business are predominantly funded through retained earnings. This is in sharp contrast to large firms, which regularly access commercial banks for working capital as well as for fixed investments. Moreover, SMEs also complain that the financing products available in the market are not designed for small firm growth, in fact, some SMEs have had poor experience utilizing a credit facility. This reduces the appetite of SMEs to borrow from the formal credit market.

9.1. CURRENT PROVISIONING

Affordable credit is essential for SMEs to start-up, expand, acquire new technologies and support a larger operating cycle. However, the provision of financing to SMEs in Pakistan has been fairly weak. At the end of December 2017, SME Financing stood at PKR 442.53 billion or just 8.73 percent of the total private sector financing in the country. The total number of borrowers were 163,696 (State Bank of Pakistan, 2017a). Figure 13 below shows a longer-term trend, suggesting that lending to SMEs has averaged at 8 percent over the last six years.

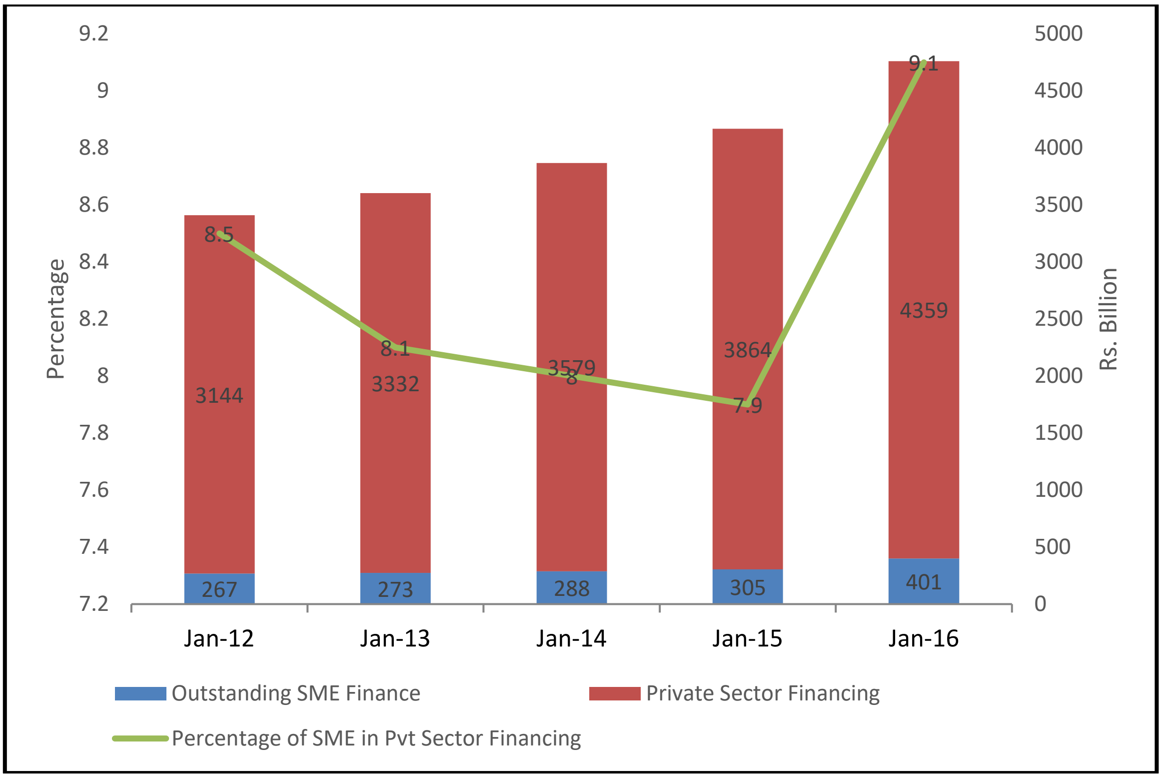

Figure 13: SME financing as compared to total private financing 2012-2016

Source: SBP, 2016

Figure 14 below provides the composition of SME financing. On average 73 percent of the credit to SMEs was provided for working capital. As of December 2017, the working capital allocation was at 68.7 percent, for fixed investment was 22.3 percent and trade finance was 9 percent. It is important to mention that use of funds under working capital, as explained in several focus groups are most fluid or fungible – SMEs generally tend to have a proclivity to use these funds on non-productive activities increasing their business risk.

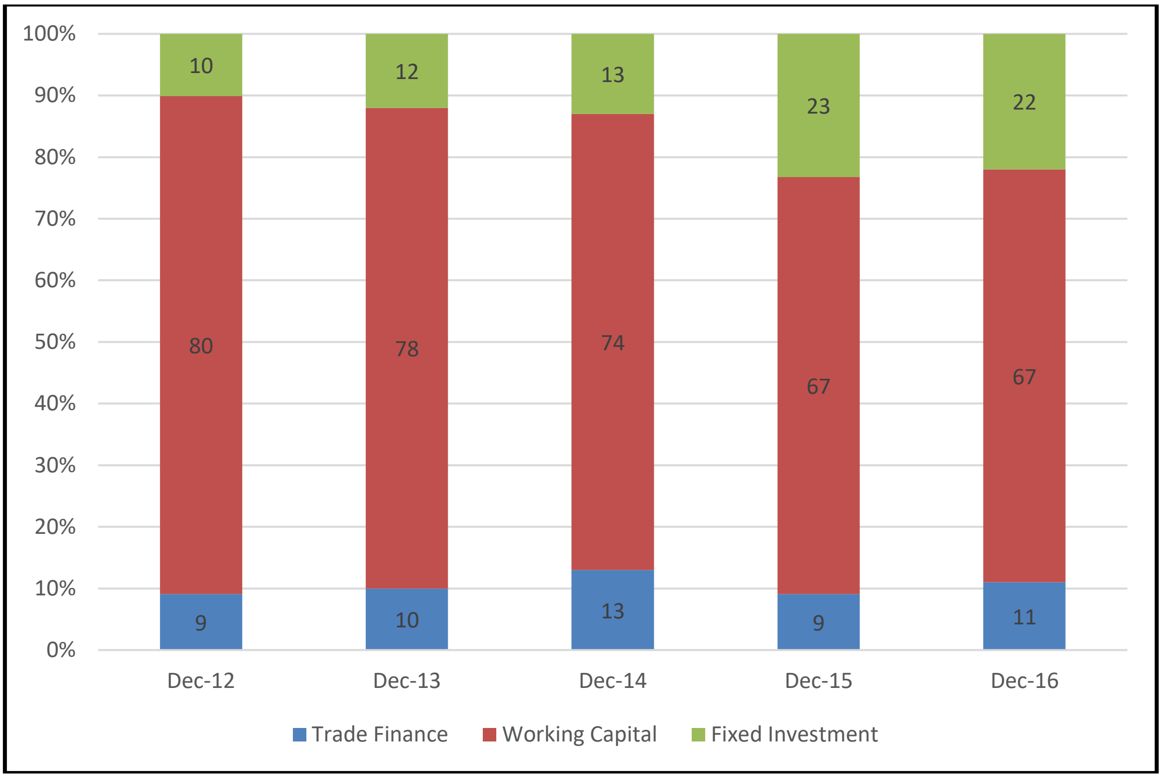

Figure 14: Composition of SME financing 2012-2016

Source: SBP, 2016

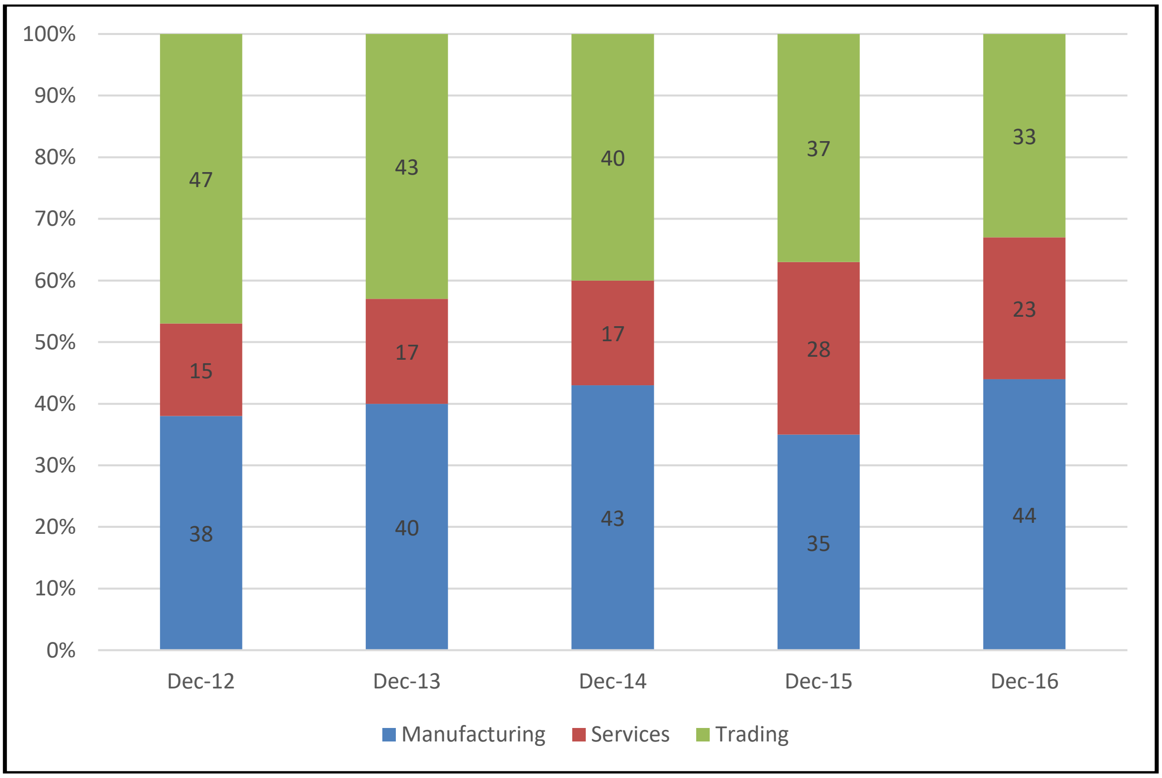

Figure 15: Sectoral distribution of SME financing 2012-2016

Source: SBP, 2016

Figure 15 above shows the sectoral distribution of credit. The allocation of credit to trading sector has gradually reduced while that of manufacturing has stayed quite static. As of December 2017, 42 percent of the allocation was made to manufacturing and 35.3 percent to trading. This pattern suggests that a significantly large portion of credit is facilitating trade, predominantly imports, rather than building the production capacity of SMEs, although, in 2016, the share of manufacturing increased by 9 percent.

The discussion above presents some critical and current issues of structure and size of SME financing in Pakistan. An underlying and important issue in allocation of credit relates to intra SME distribution of credit. As per the current definition of the State Bank, firms having revenues up to PKR 800 million fall in the category of SMEs. The State Bank only makes recommendations to commercial banks to allocate funding to overall SMEs without any specific requirements or targets set for small firm coverage. Consequently, the prevailing opinion amongst the private sector is that while medium sized firms have access to SME credit, the smaller firms are rationed out of the market. The section below summarizes the key issues and constraints on credit identified by the stakeholders.

9.2. KEY CONSTRAINTS AND ISSUES

Segmentation

As discussed in the section on SME definition, SMEs in Pakistan are sharply segmented with the distribution skewed towards small and micro firms. While the current definition differentiates between small and medium, the State Bank does not use size-based bifurcation to set specific credit allocations for small and medium firms. This usually results in the medium sized firms being better served than the small ones. There is a need for State Bank to set specific credit quotas for both small and medium firms and carefully monitor credit disbursement to both segments.

Information Asymmetries and Credit Market Failure

Information asymmetries and the risk of adverse selection, are key reasons restricting commercial banks' lending to SMEs, especially smaller firms. These concerns were brought up strongly in discussions with the commercial banks and also in the focus groups conducted with the private sector.

The set of information that small firms can provide to banks in the form of financial accounts, business information, expansion plans, feasibility studies, etc., is generally limited. This issue gets aggravated because of low levels of literacy amongst small entrepreneurs. Most small entrepreneurs in Gujrat, Wazirabad, Sialkot, Hyderabad, Peshawar, Quetta have graduated from being factory workers to owners, who find the requirements of commercial bank credit complex. Moreover, small businesses deal with bank branches in their locality, while the decision to grant loans is taken by the head office. This further accentuates information asymmetry between the borrower and the lender.

Asymmetric information here implies that the borrower (the SME) knows far more about the state of her business than the lender (the bank). The bank, therefore, has to spend a considerable amount of resources and effort to obtain a realistic assessment of the business's feasibility. Moreover, due to the semiformal nature of most small businesses, the bank might not be able to obtain the required information at all. In most cases the information might not even exist with the businesses themselves, as articulated by stakeholders in the focus groups.

The above issue results in two problems. First, banks are unable to differentiate adequately between high quality and low-quality entrepreneurs/businesses. In such a situation, interest rates do not work as a screening mechanism. High interest rates may lead to an excessively risky portfolio because of the problem of 'adverse selection', with most persistent applicants for loans being the ones with the least capacity to repay (Stiglitz & Weiss, 1981). Second, once the banks have provided the funds, they are not able to monitor or asses if the enterprise is utilizing the funds appropriately for business development or using it inappropriately for personal consumption - 'moral hazard' problem.

To address the issues resulting from information asymmetry, banks usually require that financing be collateralized, with collateral often exceeding 100 percent of the value of the loan. This, however, is problematic as most SMEs do not have many assets that can be collateralized. The issue becomes a more serious one for sectors such as ICT or basic services where the asset base is almost non-existent. The most common form of collateral is land, but that too is problematic. The issues of land titles and the slow working of Pakistan's judicial system implies that it is generally difficult and time consuming for banks to take full custody of collateral in case of default. This adds more to the costs. Consequently, the easiest option is to not lend to the small firms, especially when there are no compliance requirements. It is, therefore, not surprising that out of approximately 3 million SMEs, only 177,000 or so enjoy a loan facility (SBP, 2017a).

Risk Profile

The interviews conducted with commercial banks for this report reveal that higher risk profile of small businesses is a significant element limiting provision of credit. Most banks regard SMEs, especially small firms as riskier than large firms. SMEs face a more uncertain market environment, experience greater variance in returns and have a higher rate of failure. Most small firms are poorly equipped in terms of both human and capital resources to withstand external economic shocks. For example, a cutlery manufacturer in Wazirabad closed down his manufacturing due to the recent increase in the price of steel, a major input into his business. Furthermore, the inadequacy of accounting and costing systems often result in small firms operating in losses or at profitability levels much lower than perceived. Finally, SMEs in Pakistan operate in an ambiguous and uncertain environment regarding governance, which reduces the security of transactions. For example, according to private sector stakeholders in Swat, due to the security operation, any private land in Swat can be acquired by military for any purpose at a rate determined by the military, usually much lower than market price – this has resulted in banks refusing to accept land as collateral. Due to these higher risk factors, banks informed that they would work with small firms at a spread that is 3.0 to 4.0 percentage points more than what they would offer large firms. This makes the cost of credit prohibitive.

Transaction Costs

The banks consulted during the focus groups indicated that a major disincentive to loan to small firms is the relatively high administrative and operational costs of small loans. The cost of appraising a loan application or undertaking an assessment of a new client is independent of the size of the financing under consideration. Therefore, the cost per rupee disbursed is significantly lower on larger loans as compared to small ones. This severely reduces, if not completely eliminates, the bank's potential profits on such small loans.

Public Sector Borrowing

As of 30 June 2018, over 85 percent of the investments of banks were tied up in treasury bills and Federal Government bonds (SBP, 2018b). Public sector borrowing is excessive in Pakistan and has gradually increased because banks earn a comfortable rate of return on sovereign debt, with low risk ratings. This puts no pressure on banks to lend to the relatively riskier private sector customers.

SME Development Products

Private sector stakeholders identified that most of the products available with banks were commercial/ personal loans with no customized products designed to facilitate SME development. The scheduling of payments, effective costs and terms of the loan are such that it becomes too costly for small businesses to use. Some reported that several small businesses which were able to access credit, later on became bankrupt as they were not able to meet the repayment schedules agreed with the banks. They strongly felt that the credit products should be based on the business model of small firms and should allow some flexibility and time for firms to grow. This problem is also linked to banks having little or no information on the business models of small firms and of different sectors. This lack of capacity of banks result in generic product offering, creating an environment where riskier loans are disbursed. This is compounded by the fact that SMEs tend not to use banks for their transactions, which further limits banks' understanding of their business.

Procedural Issues

According to the commercial banks interviewed, credit disbursement decisions to small business is a second order problem. A first order problem is to get small businesses to start banking relations through the opening of a standard bank account. The processes and procedures to open a bank account are so stringent that most small businesses keep operating without an account or avoid transactions through the banking channel. In addition, SMEs fear the use of their transactions data by FBR, and consequent predatory behavior. This lack of relationship results in little or incomplete information which banks have about small businesses leading to eventual credit rationing of small firms. Thus, there must be a strong focus on convincing SMEs to bank more of their transactions as this would result in better information and details with the banks about their business prospects. Moreover, as the credit officers of banks working in the field can be heavily penalized if any information or process is missing while opening an account or processing a loan application, it creates an automatic disincentive for these officers to target small businesses.

9.3. State Bank Policy On Promotion Of SME Finance

The issues outlined above have been under discussion for some time, and given the importance of SMEs, the State Bank of Pakistan last year approved a comprehensive policy to address the financing issues of SMEs. The policy aims to increase SME share of private sector credit from existing 8 percent to 17 percent and also to increase the number of borrowers from existing 174,000 to 500,000. Additionally, the Finance Minister has recently directed the State Bank to increase the total credit to SMEs from approximately PKR 440 billion to PKR 1.8 trillion over the next five years (SBP, 2017a). The policy has nine strategic pillars summarized below:

Improving the Regulatory Framework

The policy requires State Bank to continually refine regulations that hinder growth of SME credit. Some key refinements proposed include:

- Reduction of general reserve requirement against unsecured small enterprise financing from 2 to 1 percent and making insurance optional on financing up to PKR 2 million.
- Simplifying loan applications and allowing head of banks to approve program-based products. This will speed up the process by which banks can now develop SME specific products.
- The targets in future will be based on province and gender as well, while additional sectors have been added to the list of sectors allowed refinancing.

Upscaling through Microfinance Banks (MFBs)

- The State Bank will develop legal and regulatory framework to graduate MFBs to small enterprise banks, so that they can lend out larger amounts to enterprises that are small but not micro. As a short-term fix, the policy increases MFBs lending limits to PKR 1 million from PKR 0.5 million.

Risk Mitigation Strategy

The State Bank has been running a Credit Guarantee Scheme (CGS) since 2010 to address the high-risk issue of SMEs. However, small firms have not been able to benefit. Thus, to address this issue the policy has made the following recommendations.

- Inclusion of smaller enterprises in CGS.
- Convert the guarantee scheme into a credit guarantee company to allow more autonomy and flexibility. A company can operate within a larger legal ambit.

- The provinces, for example, Punjab has earmarked funds to provide credit guarantees to the SMEs. It may be more effective if assets for guarantees are committed on a pooled basis for efficiency and economy.
- Setting up e-registry for Agri borrowers to access credit against their movable assets.

Simplified Procedure for SME Financing

- Simplify forms and reduce loan processing time from 30 days to 15 days.
- Develop a small enterprise loan document manual for ease of understanding and swift processing by banks.

Program Based Lending and Value Chain Financing

- State Bank has conducted and will continue to develop cluster-based surveys and provide the information to commercial banks to encourage value chain-based lending.

Capacity Building and Awareness Creation

- Build capacity of banks and SME for financing for development.
- Establishment of center of excellence for SME banking and finance.

Handholding of SMEs – Non-Financial Advisory Service

- SBP, SMEDA and SECP will work together to prepare structured programs to train SMEs in preparing appropriate documentation and following processes for account opening, maintenance and loan applications.

Leveraging Technology to Promote SME Financing

- Banks to be encouraged to enhance use of technology and electronic money to enhance SME business and transactions.
- Innovation challenge fund to be launched to support development of digital products in SME financing.

Simplifying Taxation Regime for SMEs

- The policy recommends reduction of taxes on banks' income derived from SME financing.
- Tax holidays on eligible start-ups and women small enterprise borrowers.
- Reduction in sales tax on service sector small enterprises.

The above policy pillars are quite comprehensive and cover several dimensions of the SME financing issue. In the recommendations section these are further elaborated and prioritized. (SBP, 2017a)

9.4. INTERNATIONAL EXPERIENCE

The problem of SME lending is not specific to Pakistan, as other comparator countries in the region and globally face similar issues. For example, since the Asian crises, the banking systems have improved significantly but the banks have been reluctant to lend to SMEs. Across Asia, start-up businesses, particularly riskier ones, find it difficult to raise finance due to strict Basel capital requirements.[19] The riskier businesses also struggle and the information asymmetries and lack of formality of records by SMEs make is harder for banks to approve financing. Most SMEs in Asia end up borrowing at much higher interest rates or by providing valuable collateral. Like Pakistan, banks prefer to lend to larger enterprises as the information is more robust and easier to acquire (Yoshino & Taghizadeh-Hesary, 2017).

The most common tool used in the developed, developing and emerging economies is the CGS. Asia is no exception and a large number of countries have used different variants of CGS to address the SME financing issue. The main function of a CGS is to make lending more attractive for banks by absorbing some of the risk. It can also help in increasing the amount of loans available for a firm beyond its own collateral. Japan for several years had a 100 percent CGS, however, recently the Japanese government has moved to partial CGS to address the problem of moral hazard – banks were not rigorous to follow up performance as they had nothing at stake. The Japanese CGS provides the same cover guarantee to all banks, however, what may work better is that banks are differentiated in terms of cover based on their performance (Yoshino & Taghizadeh-Hesary, 2017).

Similarly, India has had a CGS since 2000 and it covers 75 percent of the credit provided to micro and small industry. Indonesia in 2007 initiated the People's Business Credit scheme which covered defaults between 70-80 percent. Kazakhstan had a partial CGS covering up to 70 percent of default under the Damu Entrepreneurship Development Fund. Moreover, other countries in Asia including Malaysia, Korea, Papua New Guinea, Philippines, Sri Lanka, Thailand and Viet Nam all offer CGS schemes with defaults covered between 50-90 percent (Yoshino & Taghizadeh-Hesary, 2017).

In addition to CGS, countries have also experimented with establishing specialized banks for SME financing. For example, in Japan, Shinkin banks operate as deposit taking cooperative banks and specialize in SME financing. Korea has used the Industrial bank of Korea as the main vehicle to advance credit to SMEs. The general tendency is that these banks specialize in SME financing and are supported by government policy (Yoshino & Taghizadeh-Hesary, 2017).

[19] Basel Standards is global voluntary regulatory framework on bank capital adequacy, stress testing and market liquidity risk.

Countries have also experimented with innovative mechanisms of financing for SMEs. One such example is the use of hometown investment trust funds for risky SMEs. These are mostly used to fund riskier start-ups and can be considered as a private equity vehicle, but units in the trust fund are sold at regional bank branches, post offices or associations. It could have both individual and institutional investors. Use of such funds reduces the risk for banks as deposits are not converted to loans, it is the investments that bear the risk. Japan has launched several successful examples of such funds. However, execution of such funds requires strong financial regulations and controls to avoid any element of fraud (Yoshino & Taghizadeh-Hesary, 2017). There is also increased use of invoice discounting where business owners can leverage the value of their sales ledger. This practice is quite common in developed economies where close to 100 percent business transactions are banked and contract enforcement it effective and payment defaults are rare. Pakistan with a large number of payment defaults, lengthy and costly contract enforcement process and high degree of informality will struggle to push for such a provision.

As discussed above a critical factor restraining banks from advancing loans to SMEs is the lack of information and risk assessment. Japan has handled this well by establishing a Credit Risk Database Association. The association takes support from the government and collects reliable and credible data on SMEs. This data is then shared with banks, lending institutions and credit guarantee schemes, which can then build a credit scoring mechanism. The database in Japan has data on 2.2 million SMEs and 1.1 million sole-proprietors. The association provides sample data, statistical information and scoring services for a fee, which ensures its sustainability and future growth. A similar model in Thailand has been the establishment of the National Credit Bureau (NCB). NCB collects data on businesses and develops credit scoring and the data is shared under relevant protocols to support financing by addressing the information gaps (Yoshino & Taghizadeh-Hesary, 2017).

The State Bank has also analyzed the key instruments used by different countries to enhance SME financing support. The table below provides these instruments.

Table 10: Key instruments used by different countries to enhance SME financing support

Attributes	Countries			
	India	S. Korea	Germany	Bangladesh
Specialized banks for SME sector	✓	✓	✓	✓
Specialized bank branches for SME lending	✓	✓	✓	✓
Credit guarantee speakers	✓	✓	✓	✓
SME priority sector advances/low interest rate lending to SMEs	✓			✓
Annual lending targets for SMEs	✓			✓
Composite loans by banks to SMEs	✓			
Term Loans	✓			
Working Capital Loans	✓			
Cluster financing	✓	✓	✓	✓
Provision of specialized branches for clusters	✓	✓	✓	✓
Provision of loans without collateral/ third party guarantees	✓			✓
Credit rating of SMEs				

Table 10: Key instruments used by different countries to enhance SME financing support				
Mandatory				
Optional	✓	✓	✓	✓
Provisions for debt restructuring of advances for sick units	✓	✓	✓	
Training institutes for entrepreneurs (supported by financial institutions)	✓	✓	✓	
Priority for women entrepreneurs				✓
Priority financing for research and innovation	✓	✓		
Financing support for SME sector exports	✓	✓		

Source: SBP, 2017a.

9.5. RECOMMENDATIONS

The government over the next five years will work towards achieving the following targets.

- Increase total SME financing to PKR 1.8 trillion by the year 2023.
- Increase the number of SME borrowers to 1 million by the year 2023.
- Increase the SME share of private sector capital to 17 percent.

The government will achieve the above targets by:

Overall

- Initiate full implementation of the State Bank's 2017 policy on SME financing and establishing a monitoring task force to develop key indicators of progress and report performance on a quarterly basis. The quarterly progress may be published in the State Bank's **Quarterly SME Finance Review publication**.
- The State Bank shall review all key regulations relating to SME financing on an annual basis and implement changes to smooth out the process and reduce the cost of accessing and providing capital.

Immediate Actions

- The State Bank shall operationalize the 'movable asset registry' on a priority basis and will revise their policy to include manufacturing firms in addition to agricultural enterprises.
- The State Bank shall review the current process of account opening and documentation required by commercial banks. Any steps and documents that are not absolutely necessary must be eliminated. An awareness programs with commercial banks and SMEDA should be launched to encourage small businesses to open bank accounts. The streamlined process must also be advertised through commercial banks media coverage and publicity.
- The State Bank shall allow back to back LCs so that the exporting firms are able to use their receivables as collaterals to secure short-term financing.
- The State Bank shall start to set credit quotas based on bifurcated definition of SMEs, rather than on the overall basis. These quotas must be reviewed periodically and banks must be encouraged to increase the coverage across different sized SMEs.

- The interest rate cost has increased recently and a further increase of up to two percent in the base rate is expected in the coming financial year. This will make the cost of financing to SMEs prohibitive. Special programs may be designed to offer reduced rate to key SME sectors against well-defined performance objectives. For example, an exporting firm may be offered a reduced mark-up based on a defined export target, where failing to achieve target would result in payment at full cost. For local firms, a revenue, employment or a tax target may be specified.

Short-Term

- The government shall review the issues of SME Bank and either strengthen its operations through reform or decide on closing the bank or selling it off for effective management. In addition, State Bank will complete and approve the regulatory guidelines for MFIs to graduate to SME Banks and provide a framework under which they can operate as independent specialized banks for SMEs.
- SMEDA shall work with the State Bank to establish a Centre of Excellence for the training of banks and SMEs to address the informational gaps between the two. SMEDA will initiate short courses immediately and will work on an institutional plan to expand this activity into a self-sustaining model. The State Bank through the Non-Financial Advisory Service has already initiated training for Banks on SME lending.[20]
- State Bank shall review the CGS and ensure that the utilization increases. The State Bank shall consider the viability of incentivizing banks by offering different coverage levels based on their performance. The performance matrix may both be based on the quantum of credit and low levels of defaults claimed.
- State Bank shall work with all Provincial Governments to ensure funds earmarked for SME financing are utilized in accordance with the instruments available through the CGS or performance reduced based mark-up schemes.
- State Bank shall convert the CGS to a national credit guarantee company, where Federal Government, Provincial Governments and development partners can become contributing members. If viable, the company or the authority will be established.
- SMEDA shall strengthen its data collection role on SMEs and initiate the process of gathering industry level and firm level data required for credit scoring and risk assessment. SMEDA shall use its outreach to encourage provision of accurate data. For example, data from FBR and SECP can be collected and converted to a suitable format that protects the privacy of the data. This data can be made available to fintech companies who can use it to develop credit scoring models, such as in Japan and Thailand. The data can also be collected by SMEDA through its engagement with SMEs while offering specific training programs on dealing with loan applications. SMEDA shall conduct analysis and data analytics to be provided to banks for supporting them in assessing risk factors for lending to SMEs in key sectors. SMEDA shall carry out of a study to ascertain the viability of establishing a credit risk rating and assessment agency that can provide consulting services to banks and lending institutions to SMEs.
- The BDSF may be used to give out small grants for piloting productivity enhancement innovations by SMEs on a cost sharing basis. Second, the State

[20] The details of the programmes for 2018 is available at http://www.nibaf.gov.pk/pdf/trainings/2018/SMETrainingCalendar2018.pdf

Bank may support testing of innovative pilots focused on developing ICT based sustainable solutions for facilitating SME credit market operations.

- SMEDA shall conduct detailed value chain studies on key clusters. These studies may not only identify the gaps, but will focus on opportunities, design of supply chain actors, capture business models, and map all key players linked in the supply chain. Based on these studies, SMEDA can inform State Bank and commercial banks on opportunities available for controlling risks by lending within specific value chains. For example, bank can work with Nestle to recover small working capital loans made to livestock farmers.

Medium-Term

- SMEDA shall conduct a study and viability analysis of using innovative blended finance for enhancing the flow of resources to SMEs. This could be done by the establishment of local investment trusts. For example, an investment trust fund for Sialkot, where investors in the city can invest in a particular industry, say Surgicals. The government can put in some seed money to cover some of the risk of the investment. The study will identify the detailed regulatory environment required to implement such investment trusts. These regulation and procedures will be developed by the State Bank and support will be provided to pilot such funds in most opportune areas.

10. SKILLS AND HUMAN RESOURCE

The quantity and quality of human capital in an economy is a key determinant of productivity and competitiveness and has a significant impact on reducing multi-dimensional poverty. The availability of skilled workforce is critically important for small firms as it helps them become efficient and also invest in technology up-gradation. Lack of skills and training comes out as a key constraint to firms in almost all the competitiveness reports and doing business surveys, including the Global Competitiveness Report 2017-18, Survey by Overseas Investors Chambers of Commerce & Industry (OICCI) 2017 and World Economic Forum, Enterprise Survey 2017. In the focus group discussion with the private sector, SMEs across different sectors indicated shortage of skills as one of the top constraints. The following is a short description of the issues related to skills availability and training identified in the discussions.

Small to medium firms stand at a disadvantage in terms of acquiring skills as compared to large firms as they do not have enough financial margins to pay for training or pay higher wages to retain more productive workers. This also creates a free rider problem, where, small firms that even have the resource to train workers, are reluctant to do so because they fear losing them to their competitor, who may offer a slightly higher wage. A second issue is that for certain sectors, production is still stuck in low value-added activities and has not up-graded over several decades. These small businesses do not see skills as a binding constraint – wrongly so, as they are stuck in a gradually declining business. Thirdly, there are issues and gaps identified in terms of quality, relevance and certification of existing skills training provided in the country. Finally, there are also issues of information and coordination failures, such that, employers struggle finding the right workforce, while trained idle youth has no mechanism to access information about available jobs. The job placement mechanism in the country is very weak. Overall, the businesses strongly feel that there are severe gaps in the skills market that need to be addressed. The section below discusses issues in skill supply and demand within the existing institutional skills training setup. Based on this analysis and the issues and gaps identified by the SMEs, a final set of policy recommendations have been proposed.

10.1. INSTITUTIONAL SETUP OF TVET IN PAKISTAN

Article 25 A of the Constitution of Pakistan guarantees free and compulsory education to all children between the ages 5-16 years. This also includes provision of skills training. So constitutionally, the State is mandated to provide skills education and training to the youth of the country. Post 18th Amendment, the Federal Government is responsible for setting of standards and regulations for technical and vocational education, while the provinces are required to deliver training and skills education.

The government in collaboration with its development partners has been working to strengthen the provision of technical education in the country. The National Skills Strategy (NSS) 2009-13 provided the main policy framework for improving the sector in the country. However, the implementation of the policy has been lackluster mainly due to coordination failures among various stakeholders. More recently, the government has approved the Technical and Vocational Education and Training (TVET) Policy 2018 – 'Skills for Growth and Development'.

At the federal level, Ministry of Capital Administration and Development, Education and Professional Training Division, and Ministry of Overseas Pakistanis and HR are involved in managing the space for technical training. The key institutions under the Education and Professional Training Division include National Vocational & Technical Training

Commission (NAVTTC), National Training Bureau (NTB) and Skills Development Councils (SDCs). NAVTTC has the overall mandate to set the policy framework and develop and implement national standards on training.

At the provincial level, delivery of Skills is managed though provincial Technical Education & Vocational Training Authority (TEVTA). Each province has its own TEVTA, however, Punjab has additional institutions namely the Punjab Vocational Training Council (PVTC) and Punjab Skills Development Fund (PSDF) to deliver technical education in the province. Moreover, any private sector training institute established is required to be registered with the provincial TEVTA and has to be affiliated for examination with the provincial technical education boards.

The provincial models suffer from a critical issue that restricts development of private sector training institutes. The private sector training institutes are required to be registered with TEVTAs, an organization that also competes with private sector as it has its own training institute – a clear case of conflict of interest. Thus, the process for private sector to register a formal training facility is cumbersome and expensive. Similarly, the coordination of activities between the federal and provincial bodies is non-existent and there have been instances where NAVTTC and Punjab-Technical Education & Vocational Training Authority (P-TEVTA) have been competing for the same pool of students.

Supply of TVET in Pakistan

The TVET system in Pakistan operates through two different streams; technical education and vocational education. The delivery for these streams is managed through polytechnics, vocational training centers, apprenticeship schemes under the Apprenticeship ACT and also the informal ‘ustad-shagird’ training model. According to the private sector, the ‘ustad-shagird’ model was the most effective, however, it is on the decline if not fully eliminated from several industries.

Table 11 below shows that there are a total of 3,287 TVET institutions operational in the country. Out of these, 1,033 are offering technical education programs, while the remaining 2,245 are providing vocational training services. The technical education is predominantly provided by the public sector training institutes, while vocational training is provided by privately run training institutes. In terms of provincial split, Punjab has the highest number of training institutes. Moreover, in 2017, approximately 433,000 students were enrolled in these institutions.

Table 11: TVET institutions in Pakistan (number)

Province	Technical		Vocational		Total
	Public	Private	Public	Private	Total
Punjab	485	181	485	521	1672
Sindh	115	186	181	235	717
KPK/FATA	28	18	151	574	771
ICT	8	12	16	82	118
Total	636	397	833	1412	3278

Source: National Skills Information Sytem

In terms of popular trades, the data suggests the following patterns (National Vocational & Technical Training Commission, 2017).

- In Punjab the most popular trades for training include: (i) Auto repair; (ii) Vehicle driving; (iii) Auto CAD; (iv) Basic computing; and (v) Web graphic & designing.

- In Sindh the most popular trades include: (i) Auto CAD; (ii) Electrician; (iii) Welding; (iv) Refrigeration and (v) Tailoring & dress making and IT.
- In KPK & Federally Administered Tribal Areas (FATA) most popular trades include: (i) Electrician; (ii) Masonry; (iii) Auto CAD; (iv) Welding; (v) Basic computing and IT.

In short, the existing enrolments suggest that majority of the trainees are enrolled in skills programs that do not have a direct relevance for industry. Consequently, the industry does not see much benefit of employing these trainees. It was pointed out in the focus group discussions that the quality of the training offered was questionable as workers usually are not able to perform the tasks that the certificate lists. Consequently, small businesses prefer to hire workers that do not come from training institutes and find it easier to train them on the job. However, to improve the quality and certification, the government is now moving towards offering the National Vocational Qualifications Framework under which competency-based courses are being offered – these will result in trainees perfecting the delivery of certain tasks with more practical based assessments. However, it is still early days to note any significant improvement.

Demand of TVET

Skilled labor is a key input into the production of goods and services, and with over 90 percent of economic activity in the domain of the private sector, it determines the overall demand for skills. The private sector contributes through three main sectors: agriculture, manufacturing, and services. Agriculture absorbs more than 40 percent of the labor force; however, it has been the weakest performing sector for several years and has lost a considerable share in national GDP. The services sector is best performing, while manufacturing's share in GDP has been stagnant with some sub-sectors exhibiting intermittent growth.

The performance of the private sector across all these sectors is dependent upon the government's economic policy which sets the overall context in which the private sector operates and performs. Wage policies and labor market regulation, for example, influence the labor market's flexibility, the hiring and firing practices of firms, the aggregate demand for labor, and its distribution between formal and informal sectors (World Bank, 2013a). In Pakistan, Afraz et al. (2016) find that firms hiring labor in the formal sector have to make mandatory contributions toward EOBI, social security, and professional taxes. When added to the requirement of paying the minimum wage, these create a wedge of about 20 percent between the cost of labor to firms and the amount workers get paid. This difference does not exist if informal labor is hired. This gap is sufficiently large for firms to employ workers from the low productivity informal sector, thus reducing the demand for skills.

Post 18th Amendment to the Constitution and devolution, Provincial Governments have set up individual revenue authorities to collect sales tax on services. In the context of skills, training is considered as a service and attracts a service tax. This has increased the cost of training for the firms and has reduced the demand for skills.

Government spending and investment policies also impact the demand for skills. Large infrastructure investments, for example, create demand for various construction, engineering and specialized skills (World Bank 2013a). CPEC has attracted significant investment in infrastructure and energy projects, however, due to a lack of relevant skilled workforce most of the job openings have been filled by Chinese workers.

In addition to economic policies, the government's stance on demographic changes, globalization, technological advances, urbanization, and climate critically influences the dynamics of skills demand (World Bank 2013b). India provides a good example; there, the boom in IT and IT-enabled services increased the demand for technicians by 500,000 a year, as well as for employees fluent in the English language (Sudan, Ayers, Dongier, Muente-Kunigami & Qiang, 2010). Pakistan is also going through an expansion of the IT sector, these experiences from India can be useful in developing the skilling strategy going forward.

The government's policies and actions to support private sector development by reducing the cost of doing business and creating a conducive investment environment results in increased investments and employment opportunities. Pakistan has enjoyed a liberal investment regime, but it still ranks low (147 of 189) on the World Bank's cost of doing business indicators. This creates a drag on investment, leading to little innovation and technology upgradation and dampens growth and demand for skills. The section on regulations discuss the areas of regulatory improvements that can trigger increased demand for skills.

The skills demand is heavily dependent upon the quality of the skills being imparted. In the UK, for example, manufacturers have consistently ranked highly skilled and flexible workers as one of two top drivers of performance (the other is new product innovation). In Philippines and Indonesia, a high demand for three soft skills for managers and production staff alike: problem-solving, leadership, and communication skills have been quoted as the most important. In Vietnam, employers prioritized punctuality as the most important trait in a worker. Employers also value workers' practical and technical knowledge more than theoretical knowledge. Indian employers highlighted deficiencies in the soft skills of the graduates from engineering colleges as a major concern. The importance placed on soft skills is not surprising given the nature of work in today's economy that relies heavily on higher human capital and productivity (World Bank 2013a).

10.2. ISSUES AND CONSTRAINTS

In the discussion with the SMEs, the main issues that emerged include information and coordination failures, lack of soft skills and relevance and quality of training programs. Each of these are elaborated below.

Search and Matching – Information and Coordination Failure

The small and medium employers complain that they are not able to access any reliable information on graduates and trainees coming out of the TVET system in Pakistan. The training institutes usually have out dated data on trainees and keep no track of their whereabouts. Firms have no central access place where they can register their demand and attract better trained individuals. The website portals such as Rozee.pk, Job Assan, etc., have emerged, but they are not providing a solution to small and medium enterprises. The technology literacy of the workers required by small business in particular is low and hence such complicated websites that require Curriculum Vitaes (CVs) and several data field are unable to serve the purpose. The training institutes themselves have no job placement services. Therefore, there needs to be appropriate interventions and institutional mechanisms which improve job search and matching for workers and SMEs. These interventions would entail increased flow and availability of information and improvement in coordination between the employers and the training institutes.

Lack of Soft Skills

One of the most important areas of deficiency highlighted by the private sector was the lack of soft skills. The small and medium firms state that the workers that come out of the training institutes are unemployable due to their poor work ethic and attitudes. The workers have no respect or understanding of working in a co-environment, health and safety, factory floor discipline, managing time, punctuality, cleanliness, tolerance and good behavior and general ethics. These areas are key for workers to be productive and the current training regime has very little focus on these areas.

Relevance and Quality of Training

As identified above, the supply of TVET is focused on providing trainings that result in self-employed service providers and not factory floor relevant skills. There is big mismatch between the skills provided and the set of skills firms are looking for. This issue can only be addressed if joint training programs with industry are developed and operationalized. The private sector or industry itself can be the best quality assurer of these trainings.

10.3. National TVET Policy 2018

The recently approved TVET policy of Pakistan addresses most of the key concerns highlighted above. The main features of the policy include:

- *Moving towards an integrated national TVET system:* the policy looks to address the coordination failures between the federal and provincial TVET bodies and move towards a collaborative model rather than a hierarchal one.
- *Establishing a national qualification, assessment and certification system:* This intervention will further address the coordination and information issues as under a common framework each person trained anywhere in the country will have the same set of skills.
- *Enhance PPPs for skills:* The main purpose of this intervention is to increase the input of industry in the design of skills training and obtain a greater relevance for improving employment opportunities. The policy also seeks to establish **Pakistan Skills Partnership –** an industry led organization to lead the agenda of skills delivery and skills policy making in the country. This model has been widely used internationally.
- *Enhance collaboration among government departments:* this will be done for more efficient and stronger implementation of policy.
- *Introduction of technical high schools to be examined and piloted.*
- *Improving governance and institutional structures of TVET in the country.*
- *Ensure sustainable funding for the TVET sector:* The idea is to develop a National Skills Fund for financing special initiatives in skills. (Ministry of Federal Education and Professional Training, 2018)

10.4. Recommendations

The government over the next five years shall work towards achieving the following targets.

- Increase demand driven trainings nationally to 500,000 per year.

Overall

- Initiate full implementation of the national TVET Policy and establish a steering committee for the monitoring of its implementation, with SMEDA being made the member for SME representation.
- SMEDA may be placed on the boards of NAVTTC and all Provincial TEVTAs to voice the concerns of SMEs. SMEDA will also be represented on Skills Development Councils.

Immediate Actions

- NAVTTC in collaboration with provincial TEVTAs shall streamline the institutional overlaps and regulatory burden for opening up space in the skills sector for private sector investments. Prohibitive regulations restricting private sector growth of training providers will be eliminated and the federal and provincial overlaps and duplications will be streamlined.
- SMEDA shall coordinate with the provinces to assess the viability of the Punjab Skills Development Fund model to be replicated. Additionally, SMEDA will liaise with NAVTTC for the establishment of National Skills Fund and to secure a position on the Fund Board to voice the needs of SMEs.
- SMEDA through its network shall identify SME sector specific training needs and may conduct some pilots to test employability. Successful interventions will be shared with provincial TEVTAs for replication and scale up.
- SMEDA shall work with SMEs to develop a detailed module and design of a 'soft skills' training program and this will be shared with NAVTTC and provincial TEVTAs to be incorporated in their other courses.
- *SMEDA shall provide input in the design of the Pakistan Skills Partnership initiative and will continue to be a part of that to ensure SME voice is well represented.*

Medium Term

- Each provincial TEVTA shall develop a partnership framework under which it will work with key SME sector associations such as Surgical, Cutlery, Furniture, Marble & Stone etc. to develop industry relevant courses, content, delivery and assessment techniques.
- SMEDA shall work with SME sector associations on technology acquisition and reverse engineering for local replication and will identify the requisite skills required for the use of up-dated technology. These needs will be provided to

NAVTTC and provincial TEVTAs for development of new programs required for upgradation of technology.

- SMEDA shall work with Skilling Pakistan Initiative and provincial TEVTA to work on a sustainable model of labor market data management. It will in collaboration develop a joint job placement portal having information on needs of SMEs and the training outputs. This can be linked to the SME Portal suggested in Section 12.

11. INFRASTRUCTURE

There is sufficient empirical evidence indicating that inadequate and poor infrastructure lowers productivity and competitiveness of SMEs across all sectors of an economy. For instance, poor quality of roads, railways and telecommunications adversely affects market access for purchase of raw materials and transport of finished products, while shortages of electricity or gas puts a disproportionate cost burden on small enterprises, reducing margins and decreasing competitiveness. Therefore, both quality and quantity of physical infrastructure is a necessary condition for SME development and more broadly for economic growth. The GCI 2018 ranks Pakistan’s infrastructure at 109 out of 140 economies. Against this aggregate rank, electrification rate in terms of population percentage is at 109/140, quality of roads stands at 69/140, and road connectivity at 62/140. These numbers show that infrastructure development in Pakistan lags behind most of the economies in the world and thus needs urgent attention. Within the domain of Federal Government fall important infrastructure related areas such as electricity, national highways and strategic roads, Railways, major ports, and telecommunication. In the context of revising the SME Policy of Pakistan, this chapter, uses underlying details from existing literature along with the insights received from the focus group discussions to develop relevant recommendations.

In developing countries such as Pakistan a major challenge faced by businesses is the continued gap between demand and supply of energy which has largely resulted due to inadequate investments and poor planning. The National Electric Power Regulatory Authority (NEPRA), in its annual state of the Industry Report, concludes that approximately 20 percent of all villages, 32,889 out of 161,969, are not connected to the grid (National Electric Power Regulatory Authority, 2016). Even those households that have connections experience daily blackouts and it is estimated that more than 144 million people across the country do not have reliable access to electricity (World Bank, 2017). Although these statistics pertain to villages and households, they can be used to infer the state of energy availability to micro and small enterprises, most of which are located in residential areas. As such, availability of reliable and affordable electricity continues to be the major concern of all the SMEs. Due to this shortfall, the electricity intensive sectors such as textiles, plastic goods and paper product manufacturers are the ones that are the worst affected. A review of the electricity tariffs also shows that on average industrial sector faces relatively higher rates.

The discussion on the infrastructure and energy requirements of Pakistan in general and industrial sector in particular is not complete without mentioning the CPEC project. An extensive network of highways and railways have been planned under the portfolio of CPEC across Pakistan. Several of these projects are in the execution phase. The transportation network was designed to connect seaports in Gwadar and Karachi with northern Pakistan. This included a 1,100-kilometre-long motorway between the cities of Karachi and Lahore, reconstruction of the Karakoram Highway from Hasan Abdal to the Chinese border, and the upgradation of Karachi–Peshawar main railway line. On the energy side, financing through private consortia is being used to help alleviate Pakistan's chronic energy shortages. Majority of the energy projects are being developed as part of CPEC's fast-tracked "Early Harvest" plan.

The infrastructure related issues pertaining to energy and accessibility are closely linked with enterprise spatial location. Targeted intervention can be applied to ease out these constraints if the firms are incentivized to locate in a cluster such as an industrial estate.

The discussion on the infrastructural constraints that affect SME productivity and competitiveness and the proposed solutions thereof can be segregated into three broad areas. First, the choice of business location, and its policy implications. Industrial and commercial activity in residential areas creates noise, congestion and pollution. Besides, such scattered location choice limits the scope and impact of any policy intervention. A suggested solution is creation of a specialized zone such as an industrial estate. However, it appears from the responses of focus group discussion participants that, development of land, provision of services, upholding merit and transparency in land allotment are some major issues that have not yet been addressed adequately in the existing industrial estates. Hence policy regarding future development of new industrial estates, special economic zones etc. needs to be cognizant of these concerns. The second area pertains to the provision and improvement of overall infrastructure such as electricity, roads, etc. to the SMEs. A review of the existing policies governing use of available infrastructure and future plans indicates that policy revision can help attain enhanced efficiency and productivity. Finally, any revised or fresh policy has to be inclusive in approach and hence able to address specific geographical location based infrastructural needs.

11.1. BUSINESS LOCATION AND INDUSTRIAL ESTATES

During the recent focus group discussions conducted across Pakistan, the private enterprises representing SMEs were asked to highlight the issues faced by them in regard to finding an appropriate business location and the role of industrial estates schemes in this connection. It seems that although the policy of industrial estates was launched to help businesses, including small firms, yet there are still many gaps in implementation that have constrained full utilization of this facility. Briefly, and just to give a sense of the existing issues, it was pointed out that small and cottage industry located in residential areas are dependent upon property owners (landlords) in terms of rent and tenure. For them, moving to industrial estates is not a favorable proposition as this increases labor availability and transportation issues. In terms of city specific responses, it was pointed out that the existing industrial estates in Multan, Sialkot, Karachi and Gujranwala lack basic facilities. Further, the allotment of plots was made on the basis of political influence which resulted in deprivation of genuine businesses. Also, the choice for location of industrial estate is sometimes not made on the basis of business needs. For example, in case of Multan the industrial estate is located far from the city, with the entry road passing through the cantonment area. This hinders business activities and resultantly the colonization rate is very slow. In case of Sialkot, the Export Processing Zone (EPZ) is under-utilized but still the entry of local suppliers to EPZ is restricted. The cost of plots is very high in the garments industrial estate of Karachi which makes it unaffordable for most firms. In Hyderabad the FGD (Focus Group Discussion) participants pointed out that attractive and accessible locations are often commercialized while SMEs are restricted to less attractive locations.

An evaluation of existing industrial estates in terms of their role in economic growth measured through percentage of colonization and job creation is important before finalizing relevant policy recommendations. The Punjab Resource Management Program PRMP (2004) report on Punjab Small Industries Corporation (PSIC) presents a dismal picture in this regard. The said report indicates that since 1985 all small industrial estates in Punjab were being developed on self-finance basis. At the time the PRMP report compiled that the colonization rate in self-financed small industrial estates was extremely low – just 2 percent. A recent analysis based on the figures given in Punjab Economic Report (Punjab Economic Research Institute, 2017) shows that in 2016 colonization in these estates has reached to just 13 percent.

The apparent lack of success of small industrial estates needs a thorough evaluation. Based on the facts and analysis given in the two reports, it transpires that PSIC lacked technical capacity to plan and operate industrial estates. The lack of focus on a demand-based approach, incomplete facilities, delayed development, lack of investor selection criteria etc., are some of the major reasons for this dismal performance. The PRMP report also indicates deficits in the balance sheets and it seems that the model of land sales in industrial estates is not delivering the desired results.

A window of opportunity in terms of provision of new industrial estates is the development of SEZs under China Pakistan Economic Corridor (CPEC) portfolio. There are nine proposed SEZs under CPEC. These SEZs have the potential to achieve direct benefits in the form of increase in capital investments including FDIs, employment generation and export growth as well as indirect benefits in the form of skill up gradation, and technology transfer. The locations of SEZs under CPEC are geographically spread covering all four provinces, GB, Azad Jammu and Kashmir (AJK), Federally Administered Tribal Areas (FATA) and Islamabad. Importantly, Pakistan can benefit from the Chinese experience of effective management of SEZs. By 2009, China had established almost 1750 Special Economic Zones (SEZs) at provincial and state levels. It is estimated that, at the national level in China, SEZs accounted for about 22 percent of national GDP, 46 percent of FDI, and 60 percent of exports (Zeng 2010). These SEZs also created more than 30 million employment opportunities in China. The proposed SEZs in Pakistan shall ease out the infrastructure related constraints of SMEs and also generate significant demand for their products and services. In a potential scenario, SMEs through both backward and forward linkages can become part of the value chain of large companies and MNCs which locate in SEZs. Besides, SMEs can provide support in services such as transportation and logistics sector.

The infrastructural issues faced by small industry such as uncertainty of tenure, high rents, road access, and energy shortage can be solved by zoning of urban areas and creation of industrial clusters. However, in case of clusters, it is important to keep into consideration both supply and demand side requirements. A pertinent question is: are industrial estates exclusively developed for SMEs sustainable in the long run? Restricting industrial estates to just small industry will possibly restrict the growth of SMEs as this will not create the necessary market linkages.

Similarly, without focusing on a full set of factors of production such as provision of skilled labor, raw materials etc. the provision of land and building alone will not yield desired results. The survival and growth of a cluster is dependent on the availability of requisite facilities – a developed land ready to be put to use by the investors. Similarly, the survival and growth of firms in a cluster is also dependent on the demand of the products being produced therein. The table below lists some of the basic demand and supply side benefits accruing from a successful cluster.

Table 12: Basic demand and supply side benefits accruing from a successful cluster

Demand Side	Supply Side

Consumer proximity	Knowledge spillovers
Lowering customer search costs	Skilled labor pool
Information spillovers-customer	Sharing non-traded Inputs: Infrastructure and specialized services
Quality reputation	Access to information by potential investors
Variety of products, differentiated products and hence greater consumer utility	Competition in input markets

Source: Kuah, 2002

Perroux (1950) highlights the significance of key large firms in spatial planning. The presence of key large firms is considered significant in terms of innovation and investment. Location specific investment acts as a focus of local growth and also generates local sales.

The New Economic Geography model (Krugman, 1991) highlights the significance of market linkages, proximity to demand and lower transportation costs for the growth and survival of clusters. As such locational choice and proper spatial planning are imperative for successful industrial estates. The Japanese model of SMEs acting as suppliers of large enterprises through subcontracting has been studied widely. The recent research in this regard shows that only efficient SMEs were able to survive as sub-contractors and low productivity firms were forced to exit which also helps in improving the total factor productivity in the economy.

It is important to develop industrial estates that provide improved security, improved access to imported raw materials through bonded warehouses, and improved access to energy through dedicated feeder lines or dedicated power plants. Such, readily available land in well planned and developed industrial estates shall help attract foreign investors.

The report also recommends that government may explore the 'land lease' model for industrial estates. The Pakistan Engineering Company (PECO) factory land in Lahore may be used to pilot a small industry estate on a land lease model. The estate may include both manufacturing and services firms. IT industry may be attracted by creating vertical work-places on reasonable lease cost for IT companies to move in.

11.2. INFRASTRUCTURAL REQUIREMENTS

Energy

In the stake holder survey conducted for this study, energy came out as the top most constraints across the country despite the recent power projects undertaken by the government. Moreover, the GCI, 2018 points out high transmission and distribution losses and ranks Pakistan at 109/140. These transmission losses further aggravate the energy crisis. To indicate the impact on SMEs, the State of Economy, Quarter 2 Report by SBP (2018b) indicates that in contrast to large-scale producers the small/medium scale producers are not able to take advantage of the buoyant steel demand in the country due to their inability to lower their overhead cost in the face of high electricity tariffs.

The stakeholder meetings brought out the apparent spatial heterogeneity in energy related issues faced by SMEs across Pakistan. For small and medium enterprises located in Punjab, the unit cost of electricity or LPG is more of a constraint on growth and sustainability. While SMEs belonging to KP and Balochistan province and GB region continue to suffer from the shortfall in supply. For example, Hunza in GB is not connected with the national grid and faces 15-18 hours' load shedding. Firms from Swat reported frequent outages and complained about the small size of the electricity grid that adversely affects local industry especially tourism.

What needs to be kept in mind is that small firm across the country are more affected by energy shortages, as the coping arrangements increase their cost of production per unit by much more than medium and large firms. Besides, micro and small firms are often located outside industrial estates and hence do not benefit from uninterrupted power supply available to industrial estates.

Roads

A comparison of GCI for 2011 and 2018 shows considerable improvement in the Pakistan's road quality index, with the country's ranking moving from 115/142 to 69/140. This is a result of sustained investments in road infrastructure over the past eight years. However, most of this improvement is driven by investment in motorways and highways while regional and local roads need a lot more attention. For example, during the FGD in Swat and Quetta it was pointed out that agri-business, one of their main sectors, needs better road connectivity with major urban centers to reduce travel time for improved shelf life of fruits etc. Similarly, in GB it was felt that the number of tourists would go up significantly if there were alternative routes which would also be open in the winter season. Sections of the Karakoram Highway (KKH) are in a very poor condition which limits tourism to GB.

ICT

Several FGD stakeholders, especially those operating in the hospitality sector, indicated the issues pertaining to ICT such as internet connectivity affecting SME business. To validate their concerns, we referred to two major sources. First, we use the rankings given under Inclusive Internet Index (Economist Intelligence Unit, 2018). The Inclusive Internet Index, commissioned by Facebook and conducted by The Economist Intelligence Unit, indicates the extent to which the -internet is not only accessible and affordable, but also "relevant to all, allowing usage that enables positive social and economic outcomes at individual and group level." The current overall rank of Pakistan on this index is 68th out of 86 countries which is lower than many developing countries. Disaggregating this rank, we find that availability of ICT services is ranked at 77th with usage for fixed line services at 65th and cellular services at 78th respectively. The index also points out huge gender gap between male and female access to mobile and internet services and on this Pakistan is ranked 86$^{th.}$

Second, a recent demand side study on telecom services of Pakistan (Galpaya, Zainudeen & Amarasinghe, 2018) indicates some interesting patterns. Expectedly the quality of services is reported to be low in rural areas. However, affordability of smartphones and data rates are also highlighted as hurdles in usage of ICT. 25 percent of those who don't own a smartphone cite affordability as the main barrier to ownership and 18 percent of current internet users would use the internet more if data cost were more affordable. Most importantly, lack of digital literacy is the reason why 87 percent of those who know about e-commerce platforms don't use them to buy goods or services.

A Federal Government initiative, Universal Service Fund exists that can be helpful to overcome such issues. Universal Service Fund was established by the Government of Pakistan (Ministry of Information Technology) to spread the telecom services to all regions of Pakistan. Universal Service Fund aims to promote the development of telecommunication services in un-served and under-served areas of the country. Existing rules of the fund give no weightage to SMEs in terms of provision of telecom services.

Necessary amendments in this regard may help in overcoming this digital divide within the country (Galpaya, Zainudeen, & Amarasinghe, 2018).

11.3. Inclusive Growth Measures

Area-Specific Concerns

During FGDs, stakeholders from the SME sector also pointed out some area specific concerns. Some of these are listed below so that appropriate policy to address them can be designed.

i. SMEs operating in parts of Pakistan that have experienced excessive natural disasters (e.g., floods and earthquakes) and militancy/ extremist activities need special support.
ii. According to the stakeholders, the reconstruction of roads in Swat has been slow and of poor quality.
iii. Lack of farm-to-market roads in Swat and Sindh. This apparent inadequacy in infrastructure has resulted in the isolation of small businesses in Swat from the rest of Pakistan.
iv. Quetta, Balochistan has potential for floriculture but needs value chain support.
v. Weak -internet connectivity in GB is another issue that hampers both tourism and e-marketing platforms for home-based businesses.
vi. Population and industry in Balochistan are widely spread, lack of road infrastructure has left local industry isolated and disconnected.

11.4. SME Policy 2007 Recommendation Of Infrastructure

The SME policy of 2007 had the following policy recommendation regarding infrastructure.

Government to ensure adequate provision of physical infrastructure (roads, utilities etc.) in existing SME clusters.

The recommendation is broad in scope but does not propose any specific measure or assign any roles for the concerned agencies. Similarly, no specific targets or monitoring and evaluation measures were suggested in the policy.

11.5. Recommendations

Energy

The electricity shortfall and high tariffs are the two major issues faced by the industrial sector and have adversely affected SME productivity and competitiveness. Under the current tariff regime, residential sector is offered a block tariff and as a support measure agricultural tube wells are given subsidy on electricity charges. Given that the industrial sector faces a relatively higher tariff, the following recommendations are made to address these issues.

i. Block tariffs to Industrial Sector: The industrial units be offered block tariffs. This will incentivize the industrial enterprises to use energy efficient production processes.
ii. Connectivity to Off-grid Industry: Providing off-grid electricity to rural and remote SMEs on the pattern of IFC Lighting India Program (International Finance Commission, 2014). The Lighting India program is presently implemented in the states of Bihar, Uttar Pradesh, Rajasthan, Odisha and Assam. Its objective is to improve access to clean, affordable energy in rural India by promoting off-grid lighting products and systems, and efficient Direct Current appliances. The program works in collaboration with the private sector to remove market entry barriers, provide market insights, and help improve consumer awareness on safe lighting options.
iii. Dedicated Electricity Supply to Industrial Clusters: In order to incentivize clustering of SMEs, dedicated power plants/ supply grids be provided to industrial estates.
iv. Exemption of Load shedding: The industrial estates be exempt from load shedding during factory timings so that labor-hours are not wasted.

Roads

i. A spatial development strategy based on mapping of industrial clusters and trade corridors needs to be developed. At present only Punjab province under the Punjab Spatial Strategy is developing spatial mapping of industrial clusters and corridors. It is important that other provinces undertake similar exercises so that new road and infrastructure projects are planned to provide necessary accessibility to the industry.
ii. New and proposed SEZs, EPZs, industrial estates whether financed under CPEC or through ADP be developed in proximity to existing road networks.
iii. A road approval criterion be developed that should include considerable weightage to access to Industry/ SMEs.
iv. Feeder routes from industrial clusters be built to connect the production sites with the main artery of the CPEC.
v. East-West route linking corridors under CPEC needs to be developed to enhance route utilization.

Industrial Estates

i) Industrial estates shall allow both large and small firms to be located in close proximity. This would help in cluster growth through backward and forward market linkages between small, medium and large enterprises.
ii) The land sales model be replaced with land leasing approach. The lease be tied with medium- and long-term performance through a set of KPIs. Non-performance should result in cancellation of lease after due warnings. This approach will force the firms to perform and also help in reducing land price speculations etc.
iii) Industrial estates be approved after due sustainability analysis. That is the cluster should be able to survive after expiry of incentives such as tax rebates.

iv) Industrial estate incentives be linked with innovation. The extent of tax rebates be linked with expenditures made against R&D as in Taiwan (Invest Taiwan, n.d).
v) The industrial estates be developed following a PPPs model. The private sector should be engaged in the planning stage such as site selection, choice of industry etc. Also, the management of the industrial estate be handed over to a representative body of industrialists. The PIEDMC model of Punjab has been found successful and can be replicated in other provinces.

ICT

i) The locations (GB in particular) on the route of the high capacity optic fiber network, being developed under CPEC investment, should be provided ICT services connectivity.

Regional Equalization Measures

To ensure an inclusive growth approach, the proposed policy needs to have a spatially targeted approach for regions lagging growth and development. The deprivation level of districts can be gauged using the district level ranking given in the Planning Commission and United National Development Program (UNDP) report on Multidimensional Poverty Index (MPI) of Pakistan (Ministry of Planning, Development and Reform, 2016). The said index uses district representative household level data from Pakistan Social and Living Standards Measurement (PSLM) survey. The index is calculated using variables on education, health and standard of living. The MPI estimation in the report points out how much each of these three areas are contributing towards incidence and intensity of poverty in each district and hence provide basis for targeted interventions. Such interventions shall lead to improved productivity of all businesses especially the SMEs which have the dominant share in the market. The World Development Report (2009) suggests a 3-D and 3-I approach to deal with such area specific issues. The three major issues are listed as 3-Ds namely; population or economic activity *density*, large *distances*, and societal *division.* The report suggests corresponding solutions through adopting a 3-I approach namely; *institutions* to foster urban growth or agglomeration, *infrastructure* to overcome distances and *targeted interventions* to overcome socio-economic divides. The proposed policy may take a similar approach to deal with area specific issues.

Specifically, the proposed policy recommends the following.

Identify districts whose economies have been adversely affected by natural calamities, terrorism, poverty and inequality etc. and suggest appropriate institutional, infrastructural interventions to alleviate the situation.

11.6. MONITORING AND EVALUATION

The GCI annually provides the ranking on important infrastructure related indicators such as electricity, roads and communication. These ranks can be used to measure progress across countries and over time.

12. INSTITUTIONAL FRAMEWORK

Extant analyses of the 2007 SME Policy reveal that institutional shortcomings were a key reason that the policy did not deliver according to expectations of the sector and its larger objectives. In particular, issues of ownership, coordination, institutional capacity, and the absence of robust mechanisms to channel the voice of SMEs were salient gaps during the lifetime of the policy. Part of this was a result of limited support and power provided to SMEDA to coordinate with a large number of public sector institutions that were actually responsible for delivering on the policy targets.

The literature review as well as the research undertaken for the policy revision process provided a comprehensive diagnosis of the existing gaps in the institutional structure of the SME policy and regulatory space. Consequently, it helps inform a series of recommendations designed to ensure the successful implementation of the policy's overarching objectives and goals.

12.1. KEY FINDINGS

Capacity of SMEDA: Analysis of the 2007 SME policy revealed that SMEDA was not empowered or equipped to undertake the implementation of the policy framework. This was on account of inadequate provision of human and fiscal resources. These findings were echoed through the fieldwork process. Public and private sector stakeholders pointed out that SMEDA's capacity would need to be upgraded for it to play a more substantive role in the SME space.

Coordination and Regulatory Mandates: Given the regulatory changes introduced by the 18th amendment, stakeholders have pointed out the urgency for improved coordination efforts between provincial and federal stakeholders. Additionally, for this purpose, clarity of mandates between different tiers of government as well as different regulators is very important. This is particularly pertinent for issues such as firm registration (SECP), and regulations and targets set for the provision of credit.

Political Economy Considerations: Stakeholder consultations revealed two interrelated political economy considerations. The first was institutional conflicts between Federal and Provincial tiers of Government, with each tier responding to different incentives and dynamics. The second, and related, consideration was the outsized role of Ministry of Finance (and the FBR) in dictating the implementation and, consequently, the success of policy frameworks. This is a persisting challenge because the overall coordination of SME policy framework and other matters pertaining to the sector fall under the jurisdiction of the Ministry of Industries at the federal tier, and the Department of Industries and its attached autonomous bodies like PSIC at the provincial tier. These organizations do not carry as much heft at the apex level, when compared to the Ministry of Finance. Therefore, ensuring buy-in of policy recommendations from Finance and FBR will play a key role in their eventual success.

<u>International Lessons for Pakistan: High Capacity Nodal Organization for SME Policy</u>

Case-studies from India, China, South Korea, Turkey, Bangladesh, and Malaysia were reviewed to look at examples of what constitutes successful institutional architecture for the growth of the SME space. The cross-country review process revealed the importance of high-capacity nodal organizations; similar in intent to Pakistan's SMEDA. The findings from the review are given below, while a more detailed comparison from comparator countries is provided as an Annexure to this report:

Autonomy: The organizations enjoy considerable autonomy, financial space and senior level government support to implement its agenda. The entities are able to offer several value-added services which attract a lot of SMEs to become member of these organizations. The Indian example shows a strong revenue generation model, whereas, the Turkish model enjoys senior level government support that allows the agency to work across different sectors. The ministry behind the entity is a powerful one and has a large mandate, and in almost all cases, the parent ministry in responsible for industry and trade.

Legislative Backing: Most nodal organizations are supported by legislation. This ensures long-term institutional continuity and increases the power of the agencies to coordinate with other bodies in performing its functions.

Providing Support to SMEs (Infrastructure, Credit, Business Development): Almost all of the models of nodal organizations studied provide space to do business (industrial parks, IT parks, etc.) and also offer extensive trainings both on business development and entrepreneurship. All entities support SMEs in accessing credit, some directly run funds, while the others have made formal arrangements with commercial banks to support provision of credit. They also work with SMEs to build their capacities to meet the requirements of SMEs to obtain credit. The provision of finance is also for new businesses and start-ups. Most agencies provide marketing, branding, export market development, product development and branding support.

Internal Capacity for Delivery and Monitoring: Each organization has strong HR departments and has strong technical capabilities within the organizations to deliver the functions. They also retain ownership of a strong monitoring system that is usually in place to track specified targets.

12.2. Recommendations: Institutional Framework for Policy Implementation

The stakeholder interviews and the detailed analysis of international SMEDAs highlighted some key considerations required for institutional strengthening (See Annex 2). The key features include:

- The organizations enjoy considerable autonomy, financial space and senior level government support to implement its agenda. The entities are able to offer several value-added services which attract a lot of SMEs to become member of these organizations. The Indian example shows a strong revenue generation model, whereas, the Turkish model enjoys senior level government support that allows the agency to work across different sectors. The ministry behind the entity is a powerful one and has a large mandate, almost on all cases the parent ministry in responsible for industry and trade.

- Most of the organizations are supported by legislation such as an Act. This increases the power of the agencies to coordinate with other bodies in performing its functions.
- Almost all of the models studied above provide space to do business (industrial parks, IT parks, etc.) and also offer extensive trainings both on business development and entrepreneurship.
- All entities support SMEs in accessing credit, some directly run funds, while the others have made formal arrangements with commercial banks to support provision of credit. They also work with SMEs to build their capacities to meet the requirements on SMEs to obtain credit. The provision of finance is also for new businesses and start-ups. They also register SMEs and use information to develop credit scoring of companies for banks.
- Most agencies provide marketing, branding, export market development, product development and branding support. A large number of value-added consulting services are also being provided.
- Each organization has strong HR departments and the have strong technical capabilities within the organizations to deliver the functions.
- A strong monitoring system is usually in place to track specified targets.

Given the views of public and private sector stakeholders, as well as extant analyses of the 2007 SME Policy and international good practices summarized above, the following section provides a list of recommendations that will act as the institutional framework for successful implementation of the revised policy. It is important to mention that lack of institutional support and funding was a major reason for ineffective implementation of the SME 2007 Policy.

SMEDA: Authority versus Section 42 Company?

A key question considered was whether to retain SMEDA as an authority or change its status to a Section 42 Company. The analysis below suggests that SMEDA must be retained as an authority, however, institutional strengthening and appropriate financing is required to ensure that SMEDA is able to deliver the role envisioned in the SME Policy. The first major action should be the promulgation of the SMEDA Act immediately. The Act may incorporate extended roles in managing funds, cross-sectoral coordination, monitoring role of SME Policy implementation, strengthening of SME trade bodies, marketing and business development services and registration of SMEs.

Implications of “Authority” mode for SMEDA

- Government ownership and consistent source of funding
- Covered under legislation and so allows sustainability
- Public Sector Company model is under scrutiny by Supreme Court and National Accountability Bureau (NAB), primarily due to lack of public sector control over decisions and accusations of fiscal management
- Operations are more restrictive, have to follow the standard government procedures, however it can have strong private sector representation on the board

Implications of “Section 42 Company” mode for SMEDA

- Entity under SECP with less cumbersome procedures and swifter operations
- Private sector led board with more autonomy / Chairman can be from private sector
- The sustainability of Section 42 companies is an issue as funding sources cannot be permanently committed and raising self-financing is difficult. The federal government had established several sector companies which were given seed money and were required to raise additional finance through PSDP projects. This has not worked and most of these companies are now stale.

Internationally, both models have been used with one key element in common: having high level government ownership and commitment.

The report recommends that SMEDA should stay an authority and promulgate the Act with enhanced role and power. The power of SMEDA can be enhanced by establishing an SME Council with SMEDA being the Member Secretary. The Terms of Reference (TORs) for SME Council are proposed below.

SME Council: Terms of Reference

These Terms of Reference describe the purpose, role, functions and membership of the SME Council being established to spearhead the SME development and growth agenda of the government.

BACKGROUND

The government has developed the new SME Policy 2019. The policy provides a large number of initiatives requiring effective coordination between a number of federal ministries and with several provincial departments. The previous SME Policy was launched in 2007, however, it remained largely unimplemented primarily due to the lack of formal coordinating mechanism or body. To ensure stronger coordination, tracking of implementation, assessment and ongoing refinement, the SME 2019 Policy recommends the establishment of an SME Council. The SME Council will oversee the implementation of the policy and will ensure that all stakeholders/departments coordinate and deliver their mandated roles and responsibilities. The Minister for Industries will be the convener of the SME Council reporting directly to the Prime Minister.

The Minister shall have the following role:

- Own and implement the SME Policy 2019 and champion the agenda of SMEs within the government.
- Build a strong and effective relationship with SMEs and representative organizations, such as SME Association, be fully aware of the issues faced by SMEs and become the voice of SMEs in the Cabinet.
- Exert influence on relevant federal and provincial departments and agencies to make them consider the necessity of coordinating implementation of key SME development initiatives under the policy.
- Effectively communicate the government’s initiatives and support services launched for SMEs for a stronger understanding, ownership and subscription.

ROLE AND FUNCTIONS OF THE COUNCIL

The role of the Council is to support the government in implementing the SME development agenda fully, learn from experiences and keep refining the measures to help SMEs grow. In particular, the Council shall:

- Agree on a common definition for SMEs in Pakistan by all relevant stakeholders. The final policy report has proposed a simple and usable definition for classifying firm size based on a single variable – the annual turnover of a business. The Council will ensure that a single definition for SMEs gets adopted. It will also on regular intervals review the effectiveness of and issues with the definition and agree on refinements if required.
- Oversee the effective implementation of the SME 2019 Policy. The Council will steer the overall process of policy implementation and will push relevant federal ministries and provincial government departments to develop their strategic plans to implement the Policy. As required, it will advocate with the government and the Prime Minister to ensure that adequate funds are allocated to implement these plans.
- Conduct a regular stock take of the implementation status of key policy initiatives and evaluate the lessons from implementation in order to refine the policy and strategic plans as required.
- As required engage with different SME businesses and stakeholders to understand the effectiveness of Policy Implementation, identify problem areas and develop course correction strategies.
- Evaluate the impact on SME development as a result of the policy and bring to the table lagging areas for discussion and swift implementation, and if required table these concerns in Cabinet through the Minister.
- Advocate SME sensitive legislations, regulations, laws and intervention across the government by acting as the SME voice in the government.
- Secure relevant funding from government sources and donors to implement SME development initiatives.

REPORTINGThe council will produce a bi-annual progress report that will be presented to the Prime Minister and approval on all critical decisions will be solicited.

COMPOSITION OF THE SME Council

Reporting Body: Cabinet

1. Minister of Industries and Production – Convener
2. CEO SMEDA – Member Secretary
3. Secretary Industry, Ministry of Industries & Production
4. Secretary Commerce, Ministry of Commerce
5. Secretary Planning, Ministry of Planning
6. Chairman FBR
7. CEO National Productivity Organization
8. Director SME Finance, State Bank of Pakistan
9. Chairman NAVTCC
10. Chief Ministers (All provinces)
11. Representative from the SME Policy 2019 Team
12. Representative from SME Association
13. Representatives from National Incubation Centers
14. Representatives from 2 Commercial Banks
15. Representatives from Academia (NUST for Technology, LUMS for Social Science and Business, IBA)
16. SME Representative from Federation Chamber

17. Representatives from Overseas Chamber
18. Other members may be co-opted on need basis

Rationalizing the support structures for SMEs

The report recommends that the government should rationalize the institutional structure that is meant to lend support to SMEs.

- It recommends closure or privatization of SME Bank as discussed in the chapter on credit.
- As discussed above the sector companies set up by federal government were not able to perform due to financing and governance issues, therefore, it is recommended these sector companies are closed and the functions merged with SMEDA.
- SMEDA runs a number of cluster facilities, for example honey processing plant in Swat. These should be moved to PPP based management contracts or sold as model units. SMEDA's future activities of this nature shall have a strong exit strategy.
- Consider the possibility of merging AHAN with SMEDA.

However, it is recommended that wherever the government decides to merge organizations with SMEDA, they should be free of their existing liabilities and should be handed over to SMEDA without any historical baggage.

Enhancing SMEDA's role

SMEDA as SME Voice may be included in:

- Boards/Committees of all provincial small industries departments/entities
- Boards of all Provincial TEVTAs
- Board of NAVTCC and made part of skills sector councils
- State Bank Committee on SME Financing
- SMEDA's enhanced presence in donor programs and forums

SMEDA Organization Structure

SMEDA shall undergo HR & Institutional Review to identify critical gaps and capability assessment of the staff. The quality of the staff and their ability to deliver will be crucial for the success of the policy and also in general for the sector development. Based on the key pillars of the policy SMEDA can initiate an institutional reform process to transition its skill set to include the following capabilities:

1. **Fund Management Capacity:** *this will involve capabilities to manage grants and innovative enterprise development activities, engaging with contractors, engaging with private sector, monitoring and assessment, developing scale-up strategies and leveraging private capital for development. This could be a new wing under the existing organization structure.*
2. **Policy and Strategy Management:** *this will require capabilities to synthesize research, collect data and information on policy initiatives and monitoring and assessments. Suggest refinements to policy by conducting policy reviews. Developing sector strategies and engaging multi-sector stakeholders in design and implementation. This function will also consider establishing an SME Intelligence Unit to address issues of information for the private sector. The wing*

already exists, missing skills may be recruited. A key skill set required is on designing advocacy and communication on enabling business environment.

3. **Business Development Services:** *given the scale of the sector, SMEDA will not be able to generate sufficient funding or capacity to provide a large variety of BDS services. The skill set required is to identify BDS service providers in the private sector, consolidate their services, engage with them to short list best options and market them with SMEs. SMEDA needs the capacity to develop effective tripartite arrangements, where it can share cost for value added services for SMEs. Unit already exists, missing skills need to be added.*
4. **SME Registration & Data Management:** *a critical role identified for SMEDA under the policy include registration of SMEs and developing a data base with credible information. This will require ICT capacities, data design and management capacities. Moreover, SMEDA will use this data to develop credit scoring of SMEs which will require specialist HR. This will involve setting a new wing which going forward will generate revenues for SMEDA, as the information can provide much stronger access to credit. This unit will integrate the outreach units under the existing organization chart. This unit will also act as the SME watch dog and highlight issues and problems given that it would be the direct contact point for registered SMEs.*
5. **Entrepreneurship and Skills Expertise:** *as entrepreneurship and provision of skills are key levers of the policy, there is a need to build capacity in SMEDA to understand these areas from the perspective of SMEs in order to provide effective advocacy and support at relevant levels.*
6. **Procurement & Outsourcing:** *the new envisioned role of SMEDA will require procurement of specialized services from the market. These skills need to be built to ensure speedy procurement and one that assures quality of process.*
7. **Monitoring & Evaluation (M&E):** *SMEDA will need strong M&E capacity to ensure implementation of initiatives, obtain feedback from the field and also conduct appropriate analysis. It is also recommended that a monitoring dashboard for the M&E policy is developed.*

Establishing the Business Development Services Fund (BDSF)

The report recommends establishment of a Business Development Services Fund (BDSF) with an initial seed funding of PKR 1 billion. The BDSF will be able to access funds from the Export Development Fund (EDF) and from donor agencies willing to do match funding for particular activities under the window. The BDSF will fund on a cost sharing and grants basis the following activities:

- All Business Development Services through recognized and registered private sector providers.
- Cost sharing for international accreditation and certification
- Grants for productivity enhancement pilots that can be scaled-up
- Market information, marketing and exhibiting support
- Conducting specialized research and market intelligence activities, especially needs assessment surveys for BDS

To ensure transparent and effective management of the fund, the report proposes to set up the BDSF as a Section 42 Company with a similar design to PSDF. However, location of the BDSF can be under SMEDA or it could be set up as a separate entity under Ministry of Industries. The first location has the advantage of strengthening SMEDA and giving it more control over the fund, whereas, the latter allows the fund to be independently managed and more visible.

SMEDA's capacity building process should be envisioned as a five-year process with the following steps (Pakistan Economic Advisory Council, 2018).

Year 1 (FY 2019)

- Promulgation of SMEDA Act
- Recruitment of Chairman SMEDA from the private sector and quality HR on market-based salaries, review of the composition and membership of SMEDA Board
- Continuation of on-going development initiatives
- Creation of PKR 30 billion endowment fund for financing SMEDA activities and policy initiatives
- Creation of a PKR 1 billion Business Development Services Fund (BDSF) for grants and cost sharing under different services to be offered by SMEDA. The funds may come from EDF and from donor contributions
- Approval of Strategic Business Plan (Five Year)
- Facilitating coordination for a conducive policy environment
- Sector and cluster development
- Provision and facilitation of ongoing services
- Initiate registration of SMEs

Year 2 (FY 2020)

- Implementation of Strategic Business Plan
- Program development and piloting initiatives
- Financial services
- Technology support
- Skills and credit support
- Private sector BDS

Year 3 ~ 5 (FY 2021-2023)

- Full-scale operations: Extension in the number and scale of programs

SMEDA Actions to support SME Agenda.

- *Maintaining SME Data*: SMEDA will take the lead on development of an electronic database of SMEs to provide information on the profiles, activities and geographical location of SMEs. This database shall be similar to PRO-Net of USA and ELPRO of EU. One proposed initiative stemming from SMEDA strengthening its data collection role on SMEs is credit scoring, risk assessment, and information sharing with key government counterparts. SMEDA will use its outreach to encourage provision of accurate data, and conduct analysis and data analytics to be provided to banks for supporting them in assessing risk factors for lending to SMEs in key sectors.
- *Advocacy:* SMEDA is envisioned to take on a central role for SME advocacy and coordination of SME-related efforts. For this purpose, SMEDA is required to maintain liaison with a large number of federal and provincial institutions. For example, SMEDA can advocate for frequent data collection by the Bureau of Statistics, to help map the economy and understand the SME space. Better use of existing data can also help. For example, FBR and SECP data can be made available to fintech companies to develop credit scoring mechanisms that can in turn facilitate access to credit for SMEs.

- *Presence of SMEDA in Key Regulatory Arenas:* SME/ SMEDA representation has to be present in trade, macroeconomic, and taxation policy bodies constituted by the Ministry of Finance, FBR, State Bank, and Ministry of Commerce. This is to ensure that SME voice is present at key junctures of policymaking, and that policy makers are attentive to the needs of smaller enterprises.
- *The establishment of a SMEDA managed "SME Portal":* The policy envisions setting up of formal forum of consultation with SMEs, with capacity to outsource analytical support, which can be used for advocacy and to ensure that rule making is sensitive to SME costs. This can include online forums, and will be hosted by SMEDA. Primarily, it will help SME firms register their inputs on regulatory topics, on similar line to citizen's compliant portal. The same forum can also be used to allow firms to
    - i. find other SMEs to partner with for larger orders, or to coordinate joint fixed investments and other collaborative projects
    - ii. find suppliers or large firms that are looking for SME suppliers
    - iii. access information on all business matters that require a government interface
    - iv. find business service providers, see the feedback on the providers and the services offered, and provide a ranking and feedback after taking a service
    - v. give inputs on missing services that are required to be collated and provided to potential new business service providers.

13. SME Policy Statement And Implementation Framework

Preamble

The Government of Pakistan is undertaking a concerted effort to promote industrialization, innovation, enterprise development and export growth in the country. This effort contributes to the Government's target of creating 10 million jobs and 7 percent economic growth rate by 2023. Pakistan, with its large and growing population, natural resource reserves, geo-strategic location, and with improving global connectivity has the necessary ingredients to become a regional hub for investment, manufacturing and business.

The majority of manufacturing and business activity in Pakistan takes place in SMEs, therefore, growth in the SME sector contributes directly and substantially to overall economic growth. Facilitating rapid growth in the SME sector is consequently an important part of the government's economic strategy, as articulated in its 100-day agenda. There are over 3.2 million SMEs in the country, employing over 27 million of the labor force. Major exporting sectors such as textiles, garments, surgical goods, sporting goods, leather, footwear, IT, rice and fruits mostly comprise small and medium businesses. Similarly, within the domestic economy, SMEs contribute significantly through wholesale and retail, construction, tourism and hospitality.

The National SME Policy 2019 aims for sustainable growth of small and medium enterprises with a broader objective of enhancing their contribution in the social and economic development of the country. The National SME Policy 2019 builds on the SME Policy 2007 by incorporating the contextual change and lessons learnt. A key implementation issue faced by the 2007 policy was the lack of coordination between federal and provincial departments and inadequate financing of major initiatives. The SME Policy 2019 addresses these issues upfront by proposing a comprehensive institutional mechanism that spans federal and provincial governments. It also recommends the creation of an endowment fund and an SME support fund to finance the initiatives proposed in the Policy. Moreover, the National SME Policy 2019 is more comprehensive in its coverage of issues constraining SME growth. It covers areas such as trade and tax policy, regulatory reforms, public procurement targets, infrastructure and skills needs and entrepreneurship in more depth and detail than the previous policy. Finally, another major point of departure from the previous policy is the SME definition proposed. A simple and practical definition is proposed, based on a single variable – annual turnover – allowing for more meaningful comparisons across sectors. It also introduces a separate category for new businesses or start-ups. The policy interventions proposed take into account the new categorization of small, medium and start-up firm.

The formulation of National SME Policy 2019 is based on primary evidence gathered through a field survey consisting of data collection and interviews of over 200 businesses spread across 11 cities. The survey also included extensive discussions with public sector stakeholders and other financial and non-financial institutions that engage with SMEs. Finally, the Policy is also based on engagement with academia and think tanks, in-depth review of current SME and policy literature and thorough analysis of international good practices and their adaptability in the local context.

While the SME universe in Pakistan is diverse, with manufacturing, services and trading firms, there are some salient features – characteristics and constraints – identified in the literature and the field survey evidence, which are generalizable across sectors. These horizontal issues and constraints, summarized below, allow the design of a policy which is comprehensive and cross sectoral.

A prominent feature is the SME distribution, which is sharply skewed in favor of micro and small firms with limited amount of invested capital. These firms have minimal access to formal financial and marketing resources and services. The labor available to the SME is, on average, unskilled. Access to technology, and capacity for in-house research and product or service development is limited. Linkages between SMEs and technical universities and vocational training institutions is ineffective. As a consequence of these constraints, vast majority of SMEs, across services and manufacturing, are stuck in the low end of the value chain and supply primarily to the local market.

The SMEs within manufacturing that are relatively more competitive and are export oriented, have been historically concentrated in sectors such as Textile and Apparel, Light Engineering, and Surgical and Sports goods. Pakistan's relative export share in these sectors is stagnant with exports concentrated in globally declining sub-sectors or in low value-added products. The business and policy environment within which Pakistani SMEs operate has not encouraged inter firm collaborations. This has restricted the ability of SMEs to scale up, diversify and export. The National SME Policy 2019 is cognizant of these bottlenecks, and the interventions proposed are designed to address these systematically.

The infrastructure provision (roads, electricity, industrial estates) for SMEs, especially those in the manufacturing sector, is deficient and there exists major intra provincial and inter provincial disparities. Across the country, most SMEs in urban areas are located in congested residential spaces without suitable infrastructure. This not only is a binding constraint for firms to grow but is a serious environmental hazard for residents. Moreover, small firms face disproportionately higher costs of regulatory and tax compliances, which creates an incentive for small firms to remain informal or unregistered and thus under the radar screen of the government. The interface with government departments is perceived by businesses to be predatory and costly as reflected in the country's consistently low ranking in cost of doing business surveys. Therefore, a major thrust of the National SME Policy 2019 is to ease the cost of doing business and provide infrastructure where required.

While the National SME Policy 2019 addresses most of these horizontal constraints, it also attempts to harness the opportunities which a growing population and a large market offers. The main impetus of growth in recent years has come from the services sector, which is now the largest contributor to Pakistan's GDP. Within services, ICT and e-commerce are SME sectors with high returns, and inter sectoral linkages and spill overs which can be exploited. Along with that, hospitality and tourism, are sectors which can generate substantial income, employment and exports in the coming years. Finally, investments in energy, infrastructure and industrial parks under CPEC will bring about opportunities that need to be capitalized by the SMEs. The planned SEZs is an opportunity for joint ventures and sub-contracting with local SMEs in sectors such as garments, light engineering, auto parts and agri-processing.

Finally, the National SME Policy 2019 recognizes the enormous potential of women in contributing towards job creation and income generation in the economy. Women entrepreneurs and business owners face a host of challenges ranging from access to credit, selling their products or services in the market to registering businesses and interacting with government departments. The Policy is cognizant of these constraints and puts forward specific recommendations and concessional schemes and programs to facilitate women owned businesses.

VISION AND MISSION

Vision

An SME sector that is globally competitive and innovative, creates high value jobs, and encourages SMEs to scale up and move towards value-added exports.

Mission

Provide an enabling business and investment environment with ease of tax and regulatory compliance, and equal and sustainable access to credit, business services, productive human capital, technology and infrastructure for cross-sectoral SME growth.

POLICY PRINCIPLES

The National SME Policy 2019 is grounded in the following principles:

1. *The Policy focuses on addressing market failures that impact small firms disproportionately, such as information asymmetries in the credit and business development services markets, coordination failures in the provision of public goods such as infrastructure, and positive spill overs such as those arising from high growth, innovative firms.*
2. *The Policy accounts for capability and capacity gaps within the public sector, including reduced fiscal space. It builds a greater role of leveraging private sector resources, both financial and technical.*
3. *The Policy recognizes differences in the needs and economic contributions of high growth small firms, and small subsistence firms, providing targeted support that maintains efficiency of public expenditure.*
4. *The Policy incentivizes firms to register formally, both by reducing the direct and indirect costs of formalizing, and by offering benefits only to registered firms.*
5. *The Policy centers on improving the business environment and fostering a facilitative relationship between the state and SMEs.*
6. *The Policy recognizes that the SME agenda is broad and spread across national and provincial domains and therefore requires a strong institutional mechanism to advocate the position of SMEs, and robust mechanisms of information sharing, coordination and implementation across relevant departments.*

7. *The Policy is geographically inclusive as it emphasizes balanced provision of basic infrastructure such as roads, connectivity, power and land across the country.*
8. *The Policy takes affirmative action for gender inclusion by providing special opportunities and concessional terms to women entrepreneurs.*

POLICY FRAMEWORK

The National SME Policy 2019 is structured in a comprehensive framework to support the government in meeting the vision and mission of the policy. The framework divides the policy prescriptions in four key domains:

1. Macro Policy & Regulatory Environment: *the Policy provides broader and SME specific interventions that the government will undertake to ensure a more stable macro environment imperative for SME growth. The Policy puts forward a strategy of reform to reduce the regulatory burden that impacts the cost of doing business. This domain covers areas relating to trade policy, monetary and exchange rate policy, tax policy and compliance and regulatory interface.*

2. Supply Side Challenges: *the policy keeps into consideration the fact that due to market failures SMEs stay deprived of key inputs that are necessary for growth and competitiveness. This domain covers the provision of quality and affordable business development services, enhanced provision of suitable credit, availability of productive human capital, space and opportunities for innovation and entrepreneurship and sustainable infrastructure provision.*

3. Demand Side Challenges: *The Policy supports SMEs in improving local and international market access and increasing demand opportunities for their produce and services. The policy focuses on helping SMEs penetrate international and domestic markets, link strongly with value chains of large firms and become suppliers to the government.*

4. Institutional Mechanisms: *The Policy places a strong emphasis on strengthening the voice and representation of SMEs in the country and provides for an institutional mechanism to ensure comprehensive implementation of the policy with all government decisions being made sensitive to the requirements of the SMEs.*

TARGETS OF THE POLICY

The National SME Policy 2019 sets the following targets to be achieved by 2023:[21]

[21] The targets have been proposed at two levels. The outcome level targets provide a view on the contributions expected by SMEs at the end of the five-year period. The output targets are extracted from key policy initiatives prescribed in the policy. Some of these targets have to be finalized with SMEDA, SECP and State Bank.

Increasing the Economic Contribution of SMEs

- Manufacturing sector SMEs to sustain a growth rate of 8% per annum
  Current small-scale manufacturing growth is 8.18 percent (2017-18)
- Services sector SMEs to grow by 10% per annum
  Current services sector growth rate is 6.43 percent (2017-18)
- Average SME sector employment to increase by 5% per annum
  Employment growth in the last five years was 3.6 percent
- SME sector exports to grow by 10% per annum
  Overall Export growth rate is 8.3 percent (2017-18)

Enhancing Formalization and Increasing the Number of SMEs

- Number of new registered businesses (SECP and provincial partnerships and sole proprietorships) to grow by 10% every year.

Making SMEs more Competitive & Productive

- SME credit to increase from PKR 400 billion to PKR 1.8 trillion
- Number of SME borrowers to increase from 177,000 to 1 million
- Volume of venture capital finance to grow
- Representation of SMEDA on boards of all federal & provincial SME related agencies
- Representation of SMEs/SMEDA on the board of State Bank of Pakistan
- 500 SMEs to be certified in their relevant export market quality and compliance requirements
- Doing Business (World Bank) index ranking to improve by 30 places

Improving Networking of SMEs

- Public sector procurement from SMEs to be 10% per annum. It will increase by 5 percentage points every year to attain a maximum of 30 percent
- SMEDA to register 50,000 SMEs

Increasing Start-up Enterprises

- Start-ups supported through national incubation program and other government programs (per year) to increase from 95 in 2016 to 500 by 2023
- Registered start-ups to increase from 300 per year in 2016 to 1000 per year by 2023
- Public and private incubators, accelerators and co-working spaces to increase from 20 in 2017 to 50 by 2023

KEY POLICY RECOMMENDATIONS

1. Increasing the Voice of SMEs in Public Sector

The government shall **establish the SME Council** to lead the agenda for SME development and ensure effective implementation of the National SME Policy 2019. The SME Council shall be headed by the Minister for Industries & Production and SMEDA will act as its Secretariat. The SME Council shall hold quarterly meetings or special meetings as may be required. The SME Council shall report progress on the policy delivery to the Cabinet once every six months and ensure necessary directives are issued. More specifically the SME Council will deliver the following in the first six months:

1. Ensure a full agreement on the SME definition by all stakeholders andensure that all action plans and programs are designed based on the agreed definition.
2. Rationalize the public sector organizational structure for the support of SMEs. The Council in the first six months will review the status and suggest and implement measures for closure, merger or further strengthening, as the case may be, of sector companies under PIDC.
3. Assess the viability of Ministry of Industries & Production's organizations such National Productivity Organization (NPO), Pakistan Institute of Management (PIM) and other's merger with SMEDA.
4. SME Bank to be privatized or strengthened.
5. Strengthen financial and HR capacity of SMEDA.
6. Establish an effective coordination and information sharing mechanism for all provincial and federal departments related to the SME agenda.

7. Advocate for services sector to be declared an industry and be facilitated by the Ministry of Industries & Production.
8. Secure adequate funding for the implementation of the National SME Policy 2019.

2. SME Definition & Application

There will be one uniform SME definition as proposed below:

Table: SME definition

Category	Definition
Small	Registered, independent enterprises, with a sales turnover up to PKR 100 million
Medium	Registered, independent enterprises, with a sales turnover between PKR 100 million and PKR 650 million

3. Macro Policy & Regulatory Environment

1. All existing SROs shall be reviewed and revised into a consolidated SRO to be approved by the fiscal policy board and the parliament. Any new SRO shall be time-bound and shall go through the same process of approval.
2. Import tariffs on all raw materials, intermediate goods and machinery, which were increased from 0 to 3-5 percent in the last five years, shall be at zero tariff. Import tariffs on all the raw materials, intermediate goods and machinery at higher than 3 percent slab (11 percent, 16 percent or 20 percent slab) shall be brought down to zero – one slab down every two years.
3. Duty & Tax Remission for Exporters (DTRE) scheme shall be simplified and filing of information shall be made online.
4. Pending payments for sales tax and duty drawback refunds shall be disbursed first to SMEs.
5. The government shall establish bonded warehouses for import of key inputs such as plastic, steel, etc. The Competition Commission shall enforce strict penalties on the cartelization of commercial importers of raw materials.
6. The category of “small firms” shall be given a presumptive tax option in which they can pay 8 percent of their revenue. Small and medium firms shall pay 20 percent corporate tax, as compared to 25 percent for large firms.
7. FBR shall design tax incentives to channel savings into equity finance:
    a. Individual savings up to PKR 2 million can be invested in stocks and shares, with up to PKR 200,000 tax free dividend allowance, and no capital gains tax on increases in the value of stocks and shares.
    b. FBR shall develop a tax regime that provides tax relief for capital gains tax, and provisions for loss relief, for corporate investors to channel their savings to equity finance e.g. to incubators, accelerators and other venture capital and business angel activity.

8. Board of Investment shall make existing income tax holidays conditional on sourcing labor and inputs locally. Expenses incurred by either SMEs or MNCs that build SME vendor capacity to levels required by MNCs e.g., licensing, labor training, technology upgradation, improvement in management practices shall be made tax deductible.
9. The government has already reduced the frequency of payment of taxes from 47 to 16, it shall further refine the process of tax collection by moving to e-challans and e-payments.
10. The Tax Ombudsman at FBR shall be strengthened and separate window for SMEs will be established with a time limit set to dispose all complaints.
11. The government shall at national level and at the provincial level, initiate and implement the regulatory guillotine.[22] The refinement of the regulatory system shall be completed within one year by June 2020. This shall result in a legally binding registry of rules and regulations. Rules, regulations and compliances that are not part of this registry shall not be imposed on firms. In addition, a new system shall be put in place to ensure that regulatory impact assessment is part of the approval mechanism for any new rules and regulations. All new regulations proposed shall be approved conditional on the removal of pre-existing regulations of an equivalent cost to business. Reduced or delayed compliances shall also be considered for new firms.
12. The government, both at federal level and provincial level, shall reduce the unnecessary intrusion of inspectors at the business premises. A system shall be designed by which firms will self-report or have inspections through trade bodies in the first instance. A smaller sub-sample shall be inspected by government departments. The other more subjective inspections such as labor, etc. shall be streamlined and discretionary powers of all inspectors to shut down premises or impose immediate fines shall be withdrawn. The payment of all fees and taxes shall be made through e-challans.
13. SECP shall facilitate registration by creating an online database of names, logos and patents that can be checked in real time by firms when selecting a name.
14. Provincial departments of Industries and SECP shall host a single portal on-line registration that automatically registers the firms with selected agencies such as EOBI, PESSI, Department of Labor etc.
15. A single unique identifier shall be issued to all registered firms that can be used with all government departments to pull up relevant data electronically, precluding the need to enter information separately.
16. Department shall give a clear time-line for processing selected licenses and approvals, with penalties imposed (such as waiver of fees etc.) if the processing time is exceeded.
17. Implement & improve e-governance ranking related to facilitating SME interface with government.

4. Addressing the SME Supply Side Constraints

4 A. Business Development Services

[22] Regulatory Guillotine is a formal trademarked approach that looks at the entire universe of regulations and assesses each one for necessity, legality, business ease and costs/fee. The regulations that are found to be unnecessary or illegal are immediately eliminated and those that are constraining business are rationalized.

1. SMEDA shall undertake a needs assessment survey for Business Development Services (BDS) in the immediate term.
2. SMEDA shall link SMEs registered with SMEDA to BDS providers and will provide funding to share cost of BDS services for up to 5 years. A larger portion of costs will be shared for women-led firms. These services include (but are not limited to) support in enhancing market access and getting quality certifications, access to finance and technology, and conducting energy audits.
3. SMEDA shall host an online ranking service that allows SMEs to share feedback on BDSPs.
4. Over time, as the market for BDS develops, SMEDA shall obtain a fee for registering BDS providers and provide them access to its database of registered SMEs and negotiate cost of providing services. SMEDA shall oversee the quality and efficiency of the BDS provided.
5. SMEDA shall support SMEs in procurement of suitable technologies to increase productivity, quality and competitiveness by working with relevant bodies such as TUSDEC and Ministry of Science and Technology and others. These partner bodies shall support in providing appropriately trained labor.
6. The BDS activities will be funded through the Business Development Services Fund (BDSF).

4. B. Entrepreneurship, Innovation & Incubation

1. The government shall advocate for the adoption of the Limited Liability Partnership Act 2017 by provinces.
2. The government shall create a legal framework for crowd-funding and create suitable rules for venture capital funds to register with SECP.
3. The government shall initiate a legal review to suggest reforms to make it quicker, easier and cheaper to close a business including options to restructure debt.
4. The government shall ensure effective implementation of the Corporate Rehabilitation Act, 2018 and ensure SECP promulgates regulations to support the new law.
5. The government shall adopt a regulatory sandbox approach for monitoring and regulation of new businesses that are still evolving and developing e.g. fintech.
6. Incubators such as National Incubation Centre shall be evaluated and scaled up accordingly, including in second tier cities. There shall be reserved seats for women in incubators and accelerators.
7. The government, in partnership with the National Incubation Centre, the Higher Education Commission and the provincial departments for education, shall initiate programs for entrepreneurship skills in schools, and support teaching of entrepreneurship as a specialized stream in high schools and universities.
8. SMEDA shall initiate an Entrepreneurship boot camp to train youth for accessing the government’s youth entrepreneurship initiatives. SMEDA shall provide full hand-holding support before selection of successful candidates and post selection guidance on making the business sustainable.

4 C. Credit

1. Initiate full implementation of the State Bank's 2017 policy on SME financing and establish a monitoring task force to develop key indicators of progress and report performance on a quarterly basis. The quarterly progress may be published in the State Bank's Quarterly SME Finance Review publication.
2. The State Bank shall review all key regulations relating to SME financing on an annual basis and implement changes to smooth out the process and reduce the cost of accessing and providing capital.
3. The State Bank shall operationalize the 'movable asset registry' on a priority basis and will revise their policy to include manufacturing firms in addition to Agri-enterprises.
4. The State Bank shall put in place a system to periodically review the process of account opening and documentation required by commercial banks, to ensure that it remains streamlined. Any steps and documents that are not necessary may be eliminated. An awareness and information provision program with commercial banks and SMEDA may be launched to encourage small businesses to open bank accounts. The streamlined process must also be advertised through commercial banks, media coverage and publicity. To ensure better awareness on all aspects, SMEDA shall work with the State Bank to establish a Centre of Excellence for the training of banks and SMEs to address the informational gaps between the two. SMEDA shall initiate short courses immediately and shall work on an institutional plan to expand this activity into a self-sustaining model.
5. The State Bank shall allow back to back LCs so that the exporting firms are able to use their receivables as collateral to secure short-term financing.
6. The State Bank shall start to set credit quotas based on the bifurcated definition of SMEs, rather than on the overall basis. These quotas may be reviewed periodically and banks encouraged to increase the coverage across different sized SMEs.
7. State Bank shall complete and approve the regulatory guidelines for Micro Finance Institutions (MFIs) to graduate to SME Banks and provide a framework under which they can operate as independent specialized banks for SMEs.
8. State Bank shall review the Credit Guarantee Scheme (CGS) and ensure that the utilization under it increases. The State Bank shall consider the viability of incentivizing banks by offering different risk coverage levels based on their performance. The performance matrix may be based both on the quantum of credit and low levels of defaults claimed. State Bank shall convert the CGS to the proposed national credit guarantee company, with Federal Government, Provincial Governments and development partners becoming contributing members.
9. SMEDA shall strengthen its data collection role on SMEs and initiate the process of gathering industry level and firm level data required for credit scoring and risk assessment. SMEDA shall use its outreach to encourage provision of accurate data.
10. SMEDA shall carry out a study to ascertain the viability of establishing a credit risk rating and assessment agency that can provide consulting services to banks and lending institutions to SMEs. This shall include the possibility of using FBR/SECP data for credit-scoring models.
11. SMEDA shall conduct detailed value chain studies on key clusters. These studies will not only identify the gaps, but will focus on opportunities, design of supply chain actors, capture business models, and map all key players linked in the supply chain. Based on these studies,

SMEDA can inform State Bank and commercial banks on opportunities available for controlling risks and designing customized financial products for specific value chains.

12. SMEDA shall conduct a study and viability analysis of using innovative blended finance, such as Islamic Products for enhancing the flow of resources to SMEs. This may be done by the establishment of local investment trusts and Islamic Bonds. The study will identify the detailed regulatory environment required to implement such financing products. These regulations and procedures shall be developed by the State Bank and support shall be provided to pilot such funds.
13. SMEDA shall support the use of leasing as an alternative source of SME Financing. However, SMEDA shall conduct a detailed mapping of leasing products available and the regulations in place. Based on the analysis, SMEDA shall make recommendations to the State Bank for issuing guidelines to structure the leasing regulations and ensure that access to lease is made flexible and suitable for SMEs.
14. State Bank shall ensure better utilization of its zero rated refinance scheme for women.

4 D. Skills & Human Resource

1. Initiate full implementation of the national TVET Policy and establish a steering committee for monitoring its implementation, with SMEDA being made a member for SME representation.
2. SMEDA may be placed on the boards of NAVTTC and all Provincial TEVTAs to voice the concerns of SMEs. SMEDA shall also be represented on Skills Development Councils.
3. NAVTTC in collaboration with provincial TEVTAs shall streamline the institutional overlaps and regulatory burden for opening-up space in the skills sector for private sector investments. Prohibitive regulations restricting private sector growth of training providers will be eliminated and the federal and provincial overlaps and duplications will be streamlined.
4. SMEDA shall coordinate with the provinces to assess the viability of replicating the Punjab Skills Development Fund model. Additionally, SMEDA shall liaise with NAVTTC for the establishment of National Skills Fund and to secure a position on the Fund Board to voice the needs of SMEs.
5. SMEDA through its network shall identify SME sector specific training needs and may conduct some pilots to test employability. Successful interventions shall be shared with provincial TEVTAs for replication and scale up.
6. SMEDA shall work with SMEs to develop a detailed module and design of a 'soft skills' training program and share with NAVTTC and provincial TEVTAs to be incorporated in their other courses.
7. SMEDA shall provide input in the design of the Pakistan Skills Partnership initiative and will continue to be a part of that to ensure SME voice is well represented.
8. Each provincial TEVTA shall develop a partnership framework under which it will work with key SME sector associations such as Surgical goods, Cutlery, Furniture, Marble & Stone etc. to develop industry relevant courses, content, delivery and assessment techniques.
9. SMEDA shall work with TUSDEC and SME sector associations on technology acquisition and reverse engineering for local replication and will identify the requisite skills for the use of up-

dated technology. These needs will be communicated to NAVTTC and provincial TEVTAs for development of new programs required for upgradation of technology.

10. SMEDA shall work with Skilling Pakistan Initiative and provincial TEVTA to work on a sustainable model of labor market data management. It will support Skilling Pakistan in populating their job portal with SME data and potential areas of employment in the industry.
11. SMEDA shall advocate to increase women centric training courses and the scaling up of initiatives such as ‘Job Assan’ at the Punjab Commission for Status of Women (PCSW) that are focused on assisting women with job search and applications.

4 E. Infrastructure

1. To reduce cost of electricity for small firms, the industrial units shall be offered block tariffs.
2. The Ministry of Water and Power shall work on providing off-grid electricity to rural and remote SMEs. This shall be done in collaboration with the private sector to remove market entry barriers, provide market insights, and help improve consumer awareness on safe lighting options.
3. SMEDA shall support development of a network of companies providing innovative off grid clean energy solutions, and facilitate SMEs by negotiating provision at affordable cost and through provision of information.
4. The government shall support all provincial governments to develop spatial mapping as done by the Punjab Province. This shall then be the central planning tool for all infrastructure decisions by making them more sensitive to the connectivity needs of SME clusters. Special emphasis will be given to address the freight disadvantage and other areas resulting in regional deprivation.
5. Farm to market roads shall be built to link small and rural firms with the main corridor arteries.
6. SMEDA shall coordinate with national and provincial bodies responsible for developing SEZs under CPEC and industrial estates to ensure adequate space is allocated for SME businesses that are part of the supply chain.
7. SMEDA shall work with relevant authorities to use the government land to set up an SME industrial estate based on a land lease model to reduce set-up costs for SMEs.[23]

5 Increasing Market Opportunities for SMEs

5 A. Market Access

1. TDAP shall organize and facilitate the participation of small firms in international fairs and exhibitions on subsidized rates. The SME quota, particularly for women, shall be fully utilized in all trade delegations supported by TDAP through proper dissemination of information and support in the application process. TDAP shall specifically target SME clusters such as in

[23] Such as PECO factory at Kot Lakhpat is non-operational, occupying over 35 acres of valuable land. This land shall be used for a pilot project of setting up a lease based model industrial estate.

Balochistan, Khyber Pakhtunkhwa and Gilgit Baltistan. Private sector firms may be hired for organizing, marketing and exhibiting products at international trade fairs. The source of financing for SMEs in international trade fairs shall come from the Export Development Fund (EDF) and Business Development Services Fund (BDSF).

2. Regular trade fairs and exhibitions in all the major cities of Pakistan shall be organized for improving local market access of small businesses and cottage industries located in remote areas.
3. Permanent emporiums shall be established in major cities to exhibit the arts, crafts and cuisine of all provinces and regions of the country. The stalls in these emporia may be rented out on a rotational basis and at a subsidized rate to registered small businesses, with higher subsidies to women owned businesses.
4. Incentivize industry/cluster associations to establish SME sector specific export marketing companies by providing matching grants for conducting international marketing research, developing marketing strategies, marketing material, packaging, branding, participating and conducting trade fairs and undertaking promotional and marketing activities. The Government through SMEDA may also part-fund design, franchising, licensing, product listing fees etc. to help SMEs expand access to foreign markets. Matching grants may also be provided to sector associations for developing world-class trade and product directories for major SME clusters. The Export Development Fund (EDF) shall be used to finance these programs.
5. National Product Standards shall be developed, strengthened and implemented.
6. E-Commerce regulatory framework developed by the Ministry of Commerce shall be implemented in order to incentivize establishment of 'Online Market Place/Digital Platforms' which shall facilitate SMEs in accessing both domestic and international markets.
7. The State Bank shall expedite the approval of applications by local investors to operate payment gateways.

5 B. Public Procurement

1. Public procurement regulatory authorities shall revise procurement rules to facilitate splitting large contracts into smaller parts and reconsider the requirement of performance guarantees, bid bonds, securities and turnover restrictions that prevent SMEs for bidding for public procurement contracts.
2. A target of 10 percent shall be reserved for SMEs in public sector procurement contracts in the year 2020-2021. This will be increased by 5 percentage points every year to attain a maximum of 30 percent by 2023.
3. In order to help SMEs cope with their capacity issues, it is proposed that SMEDA shall support establishment of a procurement support unit at business support organizations such as chambers of commerce & industry & trade associations with the mandate to:
    a. Provide assistance in completing bid documents, obtaining financing, and technical assistance in complex technological bids.
    b. Maintain liaison with the government.
    c. Provide legal and technical support in case of bid rejection etc.
4. To ensure transparency and to lower the administrative cost of SMEs, all public procurement may be made through a centralized electronic portal.

5. SMEDA shall advocate with State Bank to use confirmed orders received from government as collateral to advance loans to SMEs.

6 Institutional Framework

1. SMEDA shall be further strengthened through legislative amendments, as may be required in SMEDA Ordinance 2002 to enhance its role and power.
2. SMEDA to act as SME Voice and shall be included in:
    - Boards/Committees of all provincial small industries departments/entities.
    - Boards of all Provincial TEVTAs.
    - Board of NAVTCC and made part of skills sector councils.
    - State Bank Committee on SME Financing.
    - SMEDA's enhanced presence in donor programs and forums.
3. To ensure that SMEDA has consistent funding for its operational activities, an Endowment Fund for SME Development to the tune of PKR 30 Billion shall be established.
4. Additionally, to fund more innovative activities and leverage donor finance, a Section 42 Company, Business Development Services Fund (BDSF), to act as a rolling fund to support special activities proposed in the policy shall be established.
5. An SME Council shall be established with the Minister for Industries & Production as the convener of the SME Council reporting directly to the Prime Minister and SMEDA as the Member Secretary. The SME Council will ensure that all stakeholders/departments coordinate and deliver their mandated roles and responsibilities, and will oversee the implementation of the Policy.

The Council shall provide the lead in:

i. Owning and implementing the National SME Policy 2019 and championing the agenda of SMEs within the government.
ii. Building a strong and effective relationship with SMEs and representative organizations, such as SME Associations, being fully aware of the issues faced by SMEs and becoming the voice of SMEs in the Cabinet.
iii. Exerting influence on relevant federal and provincial departments and agencies to make them consider the necessity of coordinating implementation of key SME development initiatives under the policy.
iv. Effectively communicating the government's initiatives and support services launched for SMEs for a stronger understanding, ownership and subscription.

Role and Functions SME Council

i. The role of the Council is to support the government in implementing the SME development agenda fully, learn from experiences and keep refining the measures to help SMEs grow. In particular, the Council shall:
    - Adopt a single definition for SMEs in Pakistan for use by all relevant stakeholders. It shall also on regular intervals review the effectiveness of and issues with the definition and agree on refinements, if required.
    - Oversee the effective implementation of the National SME Policy 2019. The Council will steer the overall process of policy implementation and will push relevant federal

ministries and provincial government departments to develop their strategic plans to implement the National Policy. It shall advocate with the government and the Prime Minister to ensure that adequate funds are allocated to implement the Policy.
    - Conduct a regular stock take of the implementation status of key policy initiatives and evaluate the lessons from implementation in order to refine the policy and strategic plans as required.
    - Engage with different SME businesses and stakeholders to understand the effectiveness of policy implementation, identify problem areas and develop course correction strategies.
    - Evaluate the impact on SME development as a result of the Policy and identify challenging areas for discussion and swift redressal, and if required, table these concerns in Cabinet through the Minister.
    - Advocate SME sensitive legislations, regulations, laws and intervention across the government by acting as the SME voice in the government.
    - Secure relevant funding from government sources and donors to implement SME development initiatives.
- The Council shall meet every quarter to deliberate on the functions listed above. Additional meetings may be held if needed on particularly urgent or important aspects.
- The Council shall produce a bi-annual progress report that will be placed before the Cabinet.
- The Council shall be supported by **provincial working groups** set up in each of the provinces under the Secretary, Industries Departments.. The role of these working groups shall be to ensure provincial implementation of the National SME Policy 2019 and also to bring up issues that SMEs face in the provinces that need to be addressed at the federal level.

Composition of the SME Council

- Minister for Industries and Production – Chairperson / Convener
- CEO SMEDA – Member / Secretary
- Secretary, Ministry of Industries & Production
- Secretary, Ministry of Commerce
- Secretary, Ministry of Planning, Development & Reform
- Chairman Federal Board of Revenue (FBR)
- Director SME Finance, State Bank of Pakistan
- Chairman NAVTCC
- Chairman , Planning & Development (All Provinces)
- Representative from SMEs (8)
- Representative from National Incubation Centers
- Representative from Pakistan Banks Association
- Representatives from Academia (Technology, Social Science and Business, Policy)
- SME Representative from Federation of Pakistan Chamber of Commerce & Industry
- Representative from Women Chambers (on rotation for regional representation)
- Representative from Overseas Chamber of Commerce & Industry

Other members may be co-opted on need basis.

6 a. Institutional Strengthening of SMEDA

1. **Establishing Endowment Fund for SME Development**

To ensure that SMEDA has consistent funding for its operational activities, an Endowment Fund for SME Development to the tune of PKR 30 Billion shall be established.

2. **Establishing the Business Development Services Fund (BDSF)**

The government shall establish a Business Development Services Fund (BDSF) with an initial seed funding of PKR 1 billion. The BDSF may access funds from the Export Development Fund (EDF) and from donor agencies willing to match funding for particular activities under the window. The BDSF will fund (on a cost sharing basis) the following activities:

- All Business Development Services through recognized and registered private sector providers.
- Cost sharing for international accreditation and certification.
- Grants for productivity enhancement pilots that can be scaled-up.
- Market information, marketing and exhibiting support.
- Conducting specialized research and market intelligence activities, especially needs assessment surveys for BDS.

To ensure transparent and effective management of the Fund, it is proposed to be set up as a Section 42 Company. The BDSF shall be positioned under SMEDA.

3. **SMEDA Organizational Re-alignment and capacity building**

<u>SMEDA role in supporting SME Agenda:</u>

- *Maintaining SME Data*: SMEDA will take the lead on development of an electronic database of SMEs to provide information on the profiles, activities and geographical location of SMEs. This database shall be similar to PRO-Net of USA and ELPRO of EU. One proposed initiative stemming from SMEDA strengthening its data collection role on SMEs is credit scoring, risk assessment, and information sharing with key government counterparts. SMEDA will use its outreach to encourage provision of accurate data, and conduct analysis and data analytics to be provided to banks for supporting them in assessing risk factors for lending to SMEs in key sectors.
- *Advocacy:* SMEDA is envisioned to take on a central role for SME advocacy and coordination of SME-related efforts. For this purpose, SMEDA is required to maintain liaison with a large number of federal and provincial institutions. For example, SMEDA can advocate for frequent data collection by the Bureau of Statistics, to help map the economy and understand the SME space. Better use of existing data can also help. For example, FBR and SECP data can be made available to fintech companies to develop credit scoring mechanisms that can in turn facilitate access to credit for SMEs.
- *Presence of SMEDA in Key Regulatory Arenas:* SME/ SMEDA representation has to be present in trade, macroeconomic, and taxation policy bodies constituted by the Ministry of Finance, FBR, State Bank, and Ministry of Commerce. This is to ensure that SME voice is present at key junctures of policymaking, and that policy makers are attentive to the needs of smaller enterprises.
- *The establishment of a SMEDA managed “SME Portal”:* The policy envisions setting up of formal forum of consultation with SMEs, with capacity to outsource analytical support, which can be used for advocacy and to ensure that rule making is sensitive to SME costs. This can include online forums, and will be hosted by SMEDA. Primarily, it will help SME firms register their inputs on regulatory topics, on similar line to citizen’s compliant portal. The same forum can also be used to allow firms to;

i. find other SMEs to partner with for larger orders, or to coordinate joint fixed investments and other collaborative projects
ii. find suppliers or large firms that are looking for SME suppliers
iii. access information on all business matters that require a government interface
iv. find business service providers, see the feedback on the providers and the services offered, and provide a ranking and feedback after taking a service

give inputs on missing services that are required to be collated and provided to potential new business service providers.

SMEDA shall undergo HR & Institutional Review to identify critical gaps and capability assessment of the staff. Based on the key pillars of the Policy SMEDA shall initiate an institutional reform process to transform its skill set to include the following capabilities:

- **Fund Management Capacity:** this will involve capabilities to manage grants and innovative enterprise development activities, engaging with contractors, engaging with private sector, monitoring and assessment, developing scale-up strategies and leveraging private capital for development. This could be a new wing under the existing organization structure.
- **Policy and Strategy Management:** this will require capabilities to synthesize research, collect data and information on policy initiatives and monitoring and assessments. Suggest refinements to policy by conducting policy reviews. Developing sector strategies and engaging multi-sector stakeholders in design and implementation. This function will also consider establishing an SME Intelligence Unit to address issues of information for the private sector. The wing already exists but missing skills may be recruited. A key skill set required is on designing advocacy and communication on enabling business environment.
- **Business Development Services:** given the scale of the sector SMEDA will not be able to generate sufficient funding or capacity to provide a large variety of BDS services. The skill set required is to identify BDS service providers in the private sector, consolidate their services, engage with them to short list best options and market them with SMEs. SMEDA needs the capacity to develop effective tripartite arrangements, where it can share cost for value added services for SMEs.
- **SME Registration & Data Management**: a critical role identified for SMEDA under the policy includes registration of SMEs and developing a database with credible information. This will require ICT capacities, data design and management capacities. Moreover, SMEDA will use this data to develop credit scoring of SMEs, which will require specialist HR. This will involve setting a new wing as going forward this function will generate revenues for SMEDA. This unit will integrate the outreach units under the existing organization chart. This unit, inter alia, shall highlight issues and problems being a direct contact point for registered SMEs.
- **Entrepreneurship and Skills Expertise:** as entrepreneurship and provision of skills are key levers of the policy, there is a need to build capacity in SMEDA to understand these issues from the perspective of SMEs and provide effective advocacy for SME support at relevant levels.

- **Procurement & Outsourcing:** the new envisioned role of SMEDA will require procurement of specialized services from the market. These skills need to be built to ensure speedy procurement and one that assures quality of process.
- **Monitoring & Evaluation:** SMEDA will need strong M&E capacity to ensure implementation of initiatives, obtain feedback from the field and also conduct appropriate analysis. It is also recommended that a monitoring dashboard for the M&E policy is developed.

SMEDA's Capacity Building:

SMEDA's capacity building process is envisioned as a five-year process with the following steps:

Year 1 (FY 2019 - 2020)

- Legislative Amendments in SMEDA Ordinance 2002.
- Review of the composition and membership of SMEDA Board.
- Recruitment of Chief Executive Officer from the private sector and quality HR on market-based salaries
- Continuation of on-going development initiatives.
- Creation of PKR 30 billion endowment fund for financing SMEDA activities and policy initiatives.
- Creation of a PKR 1 billion Business Development Services Fund (BDSF) for grants and cost sharing under different services to be offered by SMEDA. The funds may come from EDF and from donor contributions.
- Approval of Strategic Business Plan (Five Year).
- Facilitating coordination for a conducive policy environment.
- Sector and cluster development.
- Provision and facilitation of ongoing services.

Year 2 (FY 2020 -2021)

- Implementation of Strategic Business Plan.
- Program development and piloting initiatives.
- Financial services.
- Technology support.
- Skills and credit support.
- Private sector BDS.
- Initiate registration of SMEs.

Year 3 ~ 5 (FY 2021-2023)

Full-scale operations: Extension in the number and scale of programs.

POLICY MATRIX

Objective:	*Create an SME Sector that is globally competitive and innovative, creates high value jobs, and contributes significantly to exports*	
Key Outputs by 2023:	i. 8 percent p.a. growth for manufacturing sector SMEs ii. 10 percent p.a. growth for the services sector SMEs iii. Attain average growth in SME employment of 5 percent p.a. iv. Exports of key SME sectors increased by 25 percent v. 10 percent increase in new registered businesses every year	
Monitoring of Outputs:	1. **Outputs i & ii** reported annually by SMEDA using PBS data/Pakistan Economic Survey 2. **Output iii** annual estimation by SMEDA and factual reporting using Labor Force Survey by PBS 3. **Output iv** by SMEDA using data from Ministry of Commerce (MOC) (Quarterly) and annual data from MOC **4.** **Output v** estimated by SMEDA by using data from SECP and Provincial Industries Departments firm registration data which should be collated annually	
Sub-Outputs:		
Credit & Finance	Increase SME Credit from PKR 400 billion to PKR 1.8 trillion by 2023	State Bank
	Increase SME borrowers from 177,000 to 1 million by 2023	SMEDA to report
	Increased volume of venture capital finance	
Skills	SMEDA represented on all Provincial TEVTA Boards and NAVTCC	Notifications of relevant boards
Competitiveness	500 SMEs certified in international standards	SMEDA
	Improve Cost of Doing Business (CODB) Index by 30 points by 2023	SMEDA to report using CODB report by WB
Entrepreneurship & Start-ups	500 start-ups supported at National Incubation	SMEDA to tabulate data from different agencies
	Increase registered start-ups to 1,000 by 2023	
	Number of public-private incubators, accelerators & co-working spaces increased to 50 by 2023	
Networking & coordinating	30 percent public procurement by SMEs by 2023	SMEDA
	50,000 SMEs registered with SMEDA by 2023	

Key Inputs				
Thematic Areas	**Key Activities**	**Responsibility**	**Resource**	**Time Frame (Immediate, Ongoing in 5 years)**
Institutional	• Establishment of the SME Council • SMEDA to initiate summary through MoI for Cabinet	Ministry of Industries, SMEDA	Not immediate	*Immediate*
	• Institutional & HR review of SMEDA and promulgation of SMEDA Act	MoI, supported by SMEDA	Through MOI PSDP	*Immediate*
	• Establishment of PKR 1 billion Business Development Services Fund (BDSF) – Section 42 Company (in six months) • SMEDA endowment fund for PKR 30 billion	MoI and SMEDA	Resources through PSDP for endowment fund, EDF and Donors	*Within six months*
Area	**Key Activities/Time**	**Responsibility**	**Resource**	**Time Frame**
SME Definition	• Agree on unified SME definition across all agencies and for all practical purposes	SME Council, State Bank, FBR, SECP coordinated by SMEDA	Not required	*(Immediate)*
Area	**Key Activities/Time**	**Responsibility**	**Resource**	**Time Frame**

Taxation & Regulatory Environment	• Proposed taxation and customs reforms implemented and SME window at Tax Ombudsman operationalized	FBR, MOC Coordinated by SMEDA	Not immediate	*(Ongoing) By end Year 1*
	• Complete implementation of Regulatory Guillotine	Ministries-to be Coordinated by SMEDA	within ministerial budget	*(Ongoing)by end Year 2*
	• Streamline the inspections regime and use technology to make registration and licensing easier	Line Departments coordinated SMEDA	Resources will be required. Donor funding could be a possible avenue	*(Immediate & Ongoing)*
Area	**Key Activities**	**Responsibility**	**Resource**	**Time Frame**
Business Development Services	• Coordination of BDSPs, linking SMEs and provision of all key services	SMEDA	Through BDSF	*(Ongoing)* Registration of BDSPs by end of Year 1
Area	**Key Activities**	**Responsibility**	**Resource**	**Time Frame**
Entrepreneurship, Innovation & Incubation	• Comprehensive review and refinement of regulatory environment • Expansion of national incubation facilities • Initiation of the loan programme for youth entrepreneurship	SECP, State Bank, NICs, Planning Commission/SMEDA	From the ministerial/departmental budgets and donor funding	*(Ongoing)by beginning Year 3*
Area	**Key Activities**	**Responsibility**	**Resource**	**Time Frame**
Credit	• Implementation of State Bank	State Bank, Commercial Banks	Through the SMEDA endowment fund and	*(Ongoing) by end Year 1*

	SME Policy 2017 and bifurcated targeting of SMEs results published • Center of Excellence established, development of new SME lending products • Setting of credit-scoring models	and SMEDA	State Bank Resources	*Immediate* *(Immediate & Ongoing)*
Area	**Key Activities**	**Responsibility**	**Resource**	**Time Frame**
Skills & Human Resource	• Representation of SMEDA • Increased programs in partnership with SMEs • Institutional reform • Strengthened systems of job placements	P-TEVTAs, NAVTCC, SMEDA and private sector associations, Skilling Pakistan	Minor, through SMEDA endowment fund	*(Immediate) By end of Year 1 develop courses in partnerships* *(Ongoing)*
Area	**Key Activities**	**Responsibility**	**Resource**	**Time Frame**
Infrastructure	• Energy availability and tariff rationalization • SEZs and Industrial Estates to have adequate quota of SMEs • Pilot first IE based on land lease model	Provincial authorities, NEPRA and SMEDA	From Federal and Provincial PSDPs	*(Ongoing)Block tariff by end of Year 1* *(Ongoing)* *(six months to get approval – two years for implementation – for PECO)*
Area	**Key Activities**	**Responsibility**	**Resource**	**Time Frame**
Market Access	• Secure suitable place for SMEs at international exhibitions • Local trade fairs	SMEDA lead, to coordinate with Board of Investment (BOI) and SECP	Through SMEDA endowment fund	*(Ongoing) Identification of avenues completed in first six months*

	and establishment of permanent emporiums • Implementation of regulations for growth in digital platforms • Making opportunities for SMEs to formally integrate with MNC value chains through restructuring of existing FDI tax incentives			
Area	**Key Activities**	**Responsibility**	**Resource**	**Time Frame**
Public Procurement	• Increase SME shares in public procurement • SMEDA to network SMEs and build capacity	SMEDA, regulatory reforms by relevant procurement agencies	Potential for donor support to setup institutional arrangements	*(Ongoing)10% by Year 1* *15% by Year 2* *20% by Year 3* *25% by Year 4* *30% by Year 5*

14. ANNEXURE/ APPENDICES

ANNEX/ APPENDIX-1: REGULATORY FRAMEWORK FOR SMALL AND MEDIUM ENTERPRISES

A. Regulatory framework for Small and Medium Enterprises

1. ***General:*** The Legal and Regulatory framework of small and medium enterprises can be studied from the following seven perspectives.

a) Licensing and Registration requirements
b) Contract enforcement
c) Insolvency and bankruptcy
d) Labor and employee regulation
e) Taxation
f) Entry and exit requirements
g) Support to SMEs

2. Registration Requirements

Businesses can take a number of legal shapes in Pakistan –sole proprietorships, partnerships, companies etc. A brief explanation of the incorporation framework is as follows:

a) Partnerships or Firms

The Partnership Act, 1932 was a Federal Act before the passage of the 18th amendment, now it has come under the provincial domain. The Act establishes the office of Registrar of Firms. The Act explains the obligations and rights of partners, vis-à-vis each other and third parties. The Act requires simple information related compliance (like submission of name and place of business to the Registrar) (Partnership Act, 1932). Firms can have 2-20 members. Partnerships having more than 20 members must register as companies.

Firms are barred from the following businesses.

- Trading in stocks,
- Banking
- Insurance

The Act thinly regulates firms and does not provide a strong basis for consumer confidence in firm structures

b) Limited Liability Partnership/ Firms.

Under the Partnership Act, 1932, all partners have unlimited liability. However, the Limited Liability Partnership Act, 2017, has introduced a new type of incorporated firm, on the western pattern, to amalgamate the professional and entrepreneurial inputs.

c) Limited Liability Companies:

The Companies Act 2017 has replaced the Companies Ordinance 1984. It explains the procedure of incorporation, governance structure of companies, compliances required from companies etc. The Act is administered by the Securities and Exchange Commission of Pakistan which is a body established by the SECP Act, 1997. The Act also provides for not-for profit companies (also called section 42 companies).

The various aspects of corporate entities in Pakistan are given below.

Table 13: Various aspects of corporate entities in Pakistan

Type of company	Prohibited businesses	Membership requirements	Liability
Public Company (under Companies Act, 2017)	1.Provision of legal (to the extent of appearing before courts, etc.,) 2. Accounting services.	Listed 7 – unlimited (SECP Reg) Unlisted 3-unlimited Sec 14(1) (a)	Limited by shares /guaranty
Private Company (under Companies Act, 2017)	1.Provision of legal (to the extent of appearing before courts, etc.,) 2. Accounting services 3. Banking and Insurance	2-50 members {Section 2 (49) and Sec 14(1) (b)}	Limited by shares /guaranty
Single member company (under Companies Act, 2017)	1.Provision of legal (to the extent of appearing before courts, etc.,) 2. Accounting services 3.Banking 4.Services which are not permitted to be provided by limited liability companies	One member {Section 2 (65) and Sec 14(1) (c)}	Limited by shares
Partnership (under Partnership Act, 1932)	Banking, Insurance and any business or activity prohibited by any law.	2-20 members (Section 4 Partnership Act, 1932 & Section 9, Companies Act, 2017.)	Unlimited liability
Limited Liability Partnership (under Limited Liability	Same as above	2 – 20 (Section 2(n) of LLP Act, 2017 & Section 9,	Limited liability

Partnership Act, 1932)		Companies Act, 2017)	

As can be seen from the above table there are few businesses which have corporatization requirements. Therefore, there appears to be little legal compulsion to corporatize.

3. *Contract Enforcement*

Contract Enforcement procedures are contained in the Civil Procedure Code, 1908, the Specific relief Act, 1877, the Financial Institutions (Recovery of Finances) Ordinance, 2001 and the Small Causes and Minor Offences Ordinance, 2001. Terms of contract are regulated by the Contract Act, 1872. Contract Enforcement procedures are not uniform – there are special dispensations for banking companies and small credit holders. While there is nothing wrong with special dispensations, banking companies have obtained special dispensations because of the ineffective and inefficient civil court system- enforcing a contract requires up to 1,071 days and costs 20.5 percent of the value of the claim (World Bank, 2018). Pakistan scores 2/12 on the strength of Legal Rights Index of the IFC Doing Business Report and stands at number 156 in the ranking of 190 economies of the World in ease-of-enforcing contracts (World Bank, 2018).

4. *Insolvency and Bankruptcy*

Insolvency and bankruptcy allow businesses to exit in an orderly manner. The Provincial Insolvency Act, 1920 deals with non-corporate entities. The Act defines acts of insolvency and conditions in which petitions of insolvency may be filed. Secured creditors are barred from filing creditor applications unless they forego their security for the benefit of creditors (Provincial Insolvency Act, 1920). The Act allows a debtor to apply to the court for a protection order against arrest and detention.

Part IX, of the Companies Act 2017 deals with schemes of rehabilitation of corporate insolvency. Part X and XI of Companies Act 2017 explains the conditions in which a company may be wound up and liability of members in case of dissolution.

Pakistan's insolvency legislation suffers from a number of issues: first it is not comprehensive second it is not balanced. For instance, Insolvency practitioners are not regulated and/or involved in liquidation or rehabilitation arrangements. Imbalance between creditor and debtor rights to be gauged from the fact that while the Financial Institutions (recovery of finances) Ordinance imposes a duty on customers to fulfill their obligations to financial institutions, it does not impose any corresponding duty on financial institutions. (Financial Institutions (recovery of finances) Ordinance, 2011). Other instances of imbalance are absence of regulations prohibiting lending institutions to obtain signatures on blank documents to be used when required. This shifting arrangement runs the risk of creating retrospective obligations which is not good for business confidence.

5. *Labor and Employee Benefits*

The law relating to labor and employee benefits in Pakistan is spread over a number of enactments. Enforcement is also uneven and selective. A summary of key Pakistani laws regulating labor and employee benefits is as follows.

Table 14: Summary of key Pakistani laws regulating labor and employee benefits

Title	Applicability	Institutions established by the Institute	Purpose
Industrial Relations Act, 2010	Employers, workmen and trade unions	• Registrar of Trade Unions • Labor courts • National Industrial Relations Commission (NIRC)	• Regulates relations between employers and workmen • Provides for establishment of trade unions and employers associations • Provides for dispute resolution system • Provides for classification of workmen, regulates holidays, publication of wage rates, attendance and leaves, notices for termination of employment, eviction from residential accommodation
Factories Ac, 1934	Factories	Inspector of Factories	• Regulates health and safety in factories, work hours and holidays
Payment of Wages Act, 1936	Factories, industrial or commercial establishments	As above	• Regulates times for payment of wages • Fixes responsibility for payment of wages • Provides for deductions which may be made in wages
Workmen compensation Act, 1923	Employers (whether incorporated or not)	Commissioner for Work compensation	• Provides of payment of compensation in case of injury or disease caused during work
Employees Social Security Ordinance, 1965	Enterprises engaged in notified businesses and/or working in	Social Security Institution	• Provides for payment of contribution for sickness, maternity and injury

Table 14: Summary of key Pakistani laws regulating labor and employee benefits

	specified area		benefits
Shops and Establishment Ordinance, 1969	Shops and establishment except one-man shops	Authority (person appointed by Government)	• Regulates opening and closing of shops, holidays, termination of employment
Employees Old Age Benefits Act, 1976	Enterprises employing 5 or more persons	EOBI	• Provides for payment of Insurance for monthly old age pension
Workers Welfare Fund Ordinance, 1971	Industrial establishment s earing Rs 5 lakh per year	Workers Welfare Fund	• Provides and regulates contribution by employers for worker welfare
Companies Profit (Workers participation) Act, 1968	Companies and institutions, organizations or associations declared to be a company for the purpose of the Act	Board of Trustees	• Provide and regulates payment of profit to workers
Workers Children (Education) Ordinance, 1972	Enterprises employing 10 or more persons	Social Security Institution	• Provides for payment of a cess for education of workers' children
Employees Cost of Living (Relief) Act, 1973	Establishments within the meaning of the shops and establishment ordinance, factories as defined in the Factories Act, Mines etc.	1. Authority under Shops and Establishments Ordinance, 1969 (for shops & establishments) 2. Authority under payment of Wages Act, 1936	• Provides for payment of a cost of living allowance
Minimum Wages Ordinance, 1961	Extends to workers for skilled, technical or manual work except coal and agricultural workers	Minimum Wages Board	• Provisions of minimum wages for an industry for which no adequate machinery exists for effective regulation of wages
Minimum Wages for unskilled workers Ordinance, 1969	Commercial and Industrial establishments	Violations punishable by Court	• Provides for minimum rates of wages for unskilled workers employed in commercial and industrial establishments.

6. *Business entry and exit requirements*

Business entry and exit requirements are few. Key businesses which require a license to operate are:

a) Arms and ammunition

b) Hospitals and clinics

c) Livestock AI services

d) Hotels and restaurants

However, most businesses have no entry and exit requirements which makes way for variable quality.

ANNEX/ APPENDIX-2: COMPARISON OF INTERNATIONAL SMEDA'S

SMEDA type organizations have been established across the globe and they generally work for the up-gradation and growth of cottage, small and medium enterprises. The section below provides a summary of key functions and structures of key regional organizations. The material discussed below has been extracted for the websites of these organizations.

National Small Industries Corporation (NSIC, India)

NSIC is an ISO 9001 certified organization established under the Ministry of Micro, Small & Medium Enterprises of India. The strategic objective behind the establishment of the NSIC was. "*to aid, counsel, assist, finance, protect and promote the interest of small industries in India.'* However, the Government of India later promulgated the Micro, Small & Medium Enterprises Development Act 2006, which expanded the role of NSIC to support medium enterprises as well. NSIC is a fully autonomous body headed by Chairman, supported by two functional directors, two nominee directors of the government and two non-executive directors. The 2018, Annual Accounts show that the organization work on self-revenue generation through collection of various fees and profits on activities. The annual income of NSIC in 2017/18 was approximately US$363 million, out of which government grant was only 2.2 percent. It has some outstanding loans, mostly were provided by the government, but are well on track to be paid off. The key services provided by NSIC include:

- Financial assistance by way of hire-purchase scheme for purchase of machinery and equipment and it also facilitates businesses by purchasing huge quantities of key raw materials and distributes then to small industries in industrial estates at reasonable prices.
- It provides marketing assistance and helps small firms in exporting their products across the globe.
- Provides training to workers of small and medium enterprises in a variety of trades.
- Helps in the development and up-gradation of technology and modernization of industries and also construct and operationalize industrial estates. It also sets up small scale industry in other developing countries on turn-key basis and sells them to Indian investors or buyers in the country.
- It directly facilitates credit requirement of small firms for raw material, local and international marketing and exports. It has also developed strategic alliances with

commercial banks to connect businesses and help them acquire long term investment and working capital loans.

- Support marketing and business linkages by collecting and disseminating domestic and international marketing intelligence, connecting SMEs and large/ bulk buyers, support SMEs to formulate consortia for pooling of capacities to meet large orders and facilitate sustainable international partnerships.
- It has established software technology parks in New Delhi and Chennai offering reasonably priced space and it also offer one-stop, one-window bouquet of aids that will provide information on business & technology ad also exhibit the core competence of MSMEs. (National Small Industries Corporation, n.d.)

China Association of Small & Medium Enterprises (CASME, China)

CASME is non for-profit organization established in 2006. It was sponsored by National Development and Reform Commission and was sponsored by the National Development and Reform Commission and was supported and approved by the State Council. CASME is supported by the government and acts as the premier agency working on SME development. The key services to SMEs offered by CASME include:

- It provides an international platform for SMEs to collect and publish information and provide services for SMEs to develop new products and markets, bring in talents and technologies and participate in government and international procurement. It also organizes with members (SMEs) to export and acquire technology.
- It conducts various types of trainings, workshops and high-level forums to improve overall qualities of entrepreneurship.
- Support evidence base for policy and regulatory reform for SMEs.
- Support SMEs in brand development and marketing. (China Association of Small and Medium Enterprises, n.d.)

Ministry of SMEs and Start-ups (MSS, Korea)

MSS established in 1996 runs under the Ministry of Trade, Industry and Energy. The very mandate of the parent ministry provides a lot of coordination and cross cutting to MSS. MSS is an autonomous body governed by the Government of Korea. The organization has a tall structure and is headed by a minister and supported key director generals. The key functions performed by the MSS include:

- Financing facilities such as financing funds and supporting schemes for high growth SME. It also supports high potential small and medium sized start-ups with strong technology and business models.
- It runs targeted programs to support start-up companies and venture companies. It provides venture incubator association service, leverage collaborations with leading universities to encourage and teach entrepreneurship. Develop program to co-invest in start-up joint ventures and similar other activities.
- It provides technology acquisition policy information for SMEs who have difficulties in technological development. Support technology acquisition funds.
- MSS offers one stop business support where they address any issues faced by SMEs. They even visit the business sites to address all issues.
- MSS also support businesses in awareness improvement and market development support by promoting SME products and hosting and financing exhibitions. Also support

export by supporting development of online channels and globalization of SMEs by establishing a network with foreign government sand organizations supporting SMEs. They also support enterprise support programs, collaborate with export related agencies.

- It also supports 50-70 percent of the cost required to acquire overseas standard certification, required by the export target country. (Ministry of SMEs and Startups, n.d.)

Small & medium Industry Development Organization (KOSGEB, Turkey)

KOSGEB was established in 1990 as a semi-governmental institution affiliated with Ministry of Industry and Trade. KOSGEB is a fully autonomous body governed by the Government of Turkey. The organization reports to the General Assembly through its executive committee and that is where it draws its power to push the SME agenda across the government. The key functions performed by KOSGEB includes:

- KOSGEB implements a large number of entrepreneurship courses designed to cater for university students as well as those starting informal small businesses. The training is usually delivered free of cost.
- KOSGEB supports the start-up culture by supporting formation of not-for-profit basis incubators, rather than directly funding start-ups. They have developed a workable model of business incubator and the initiatives that pass a minimum standard are allowed to use the KOSGEB logo.
- KOSGEB also provides start-up grants and start-up loans at zero mark-up.
- KOSGEB has also signed agreements and protocols with commercial banks to provide credit at an agreed rate to SMEs. The eligibility rules are determined by KOSGEB. SMEs have to be registered with KOSGEB and provide information to benefit from this credit program.
- KOSGEB has networked with laboratories to provide the SMEs with testing and certification facilities at reasonable cost to enhance exports.
- Additionally, market research, promotion services and value-added consulting services are provided to SMEs. Support is also provided to companies for achieving quality improvements and product diversification. (Small and Medium Industry Development Organization, n.d.)

Bangladesh Small & Cottage Industries Corporation (BSCIC, Bangladesh)

BSCIC has been established under the BSCIC Act and is an autonomous body under the government. The entity has an independent board appointed by the government and the Chairman of the Board is the Chief Executive Officer. BSCIC has four regional offices and 64 district offices. Through its extensive network of offices, the BSCIC offers the following services.

- BSCIC offers pre-investment services such as, scouting of investors, providing entrepreneurship development training, supporting the preparation of project profile and proposals, support credit arrangements and help with sorting out the registration process.
- Post investment, the entrepreneurs are supported with provision of product prototype development facility, gathering and supporting technical information, coordination between buyers and sellers, providing details of sub-contractors, developing industrial estates with infrastructure development and running of training programs. They also run

design centers, credit assistance initiatives and skills development. (Bangladesh Small and Cottage Industries Corporation, n.d.)

Small & Medium Enterprise Corporation (SME Corp, Malaysia)

SME Corp was established in 1996 by the Ministry of International Trade and Industry. The ministry has the overarching role to implement policies for industrial development and domestic and foreign trade. Through this mandate of the ministry the SME Corp. is able to influence and coordinate implementation of SME support policies. The key function performed by SME Corp include:

- Providing branding and marketing support to SMES. The run initiatives such as the branding and packaging mobile gallery supporting rural enterprise to brand their products. It also runs the national mark of Malaysian Brand Certification program. Local companies are stringently audited against pre-specified standards and quality seal is awarded to successful businesses.
- It runs several financing and credit schemes to support SMEs. It runs soft loans scheme for SMEs, shariah-compliant SME financing and an SME emergency fund for repair and maintenance in case of destruction caused by a natural disaster.
- To increase capabilities of entrepreneurs it runs programs such as business accelerator program, SME-University internship program, SME mentoring program and have an exert advisory services for SMEs.
- SME Corp support business to innovate and support use of newer technologies in business supply chains. For example, critical support was provided for enabling the e-payment for SMEs and micro-entrepreneurs.
- Provide advisory support and information to enhance market access.
- They also run special programs for women entrepreneurs. (Small & Medium Enterprise Corporation, n.d.)

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