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The Potential Role of the SME Sector in Pakistan in a World of Increasing International Trade

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A major challenge to economic policy in Pakistan at this time is to energise the private SME sector of the economy. This follows in part from the fact that other sectors are unlikely, under present circumstances, to provide the needed growth either of output or of reasonably remunerative employment; in fact, there will be a major employment challenge over the coming years as labour supply continues to expand rapidly and as neither the large-scale private sector nor the public sector are poised to create significant numbers of jobs, and though agriculture and the non-agricultural microenterprise sector can and probably will do so the levels of productivity and hence of remuneration are likely to be unattractively low. By contrast, the SME sector does have substantial untapped potential to contribute to those objectives; both economic logic and the experiences of other developing countries point to that potential, as well as providing evidence on how it may be achieved. A dynamic SME sector is an important complement to a more open economy; in most of the countries which appear to have reaped major benefits from export orientation the SME sector has been importantly involved in that process. Achieving the maximum contribution from SME, however, will require significant improvements in the support system. If achieved it will not only constitute an important source of dynamism in and of itself, but will also complement efficient large enterprise, strengthen the demand for agricultural products, and make it easier for microenterprise to graduate into the SME size range.

1. INTRODUCTION

One of the major challenges to economic policy in Pakistan at this time is to energise the private SME sector of the economy. Put negatively, this follows from the fact that other sectors are unlikely, under present circumstances, to provide the needed growth either of output or of reasonably remunerative employment; in fact, there will be a major employment challenge over the coming years as labour supply continues to expand rapidly. Put positively, it follows from the fact that this sector has substantial untapped potential to contribute to those objectives; both economic logic and the experiences of other developing countries point to that potential, as well as providing

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evidence on how it may be achieved. A dynamic SME sector is an important complement to a more open economy; in most of the countries which appear to have reaped major benefits from export orientation the SME sector has been importantly involved in that process. Achieving the maximum contribution from SME, however, is not automatic even though the sector often displays considerable dynamism in the face of little policy support. That dynamism is likely to be more impressive when good support is provided, however, and support is especially likely to be pivotal in a more open economy where failure to quickly achieve adequate levels of efficiency and productivity is punished quickly.

That small and medium enterprise plays an important role has been increasingly recognised over the last twenty years, both in an extensive literature which emphasises that role and in the policy rhetoric of many developing countries. Policy support is less far along, except for a few countries, most of them in East Asia; despite interesting advances and innovations in a number of other countries, most (including Pakistan) are far from having well designed and implemented support systems. The gap between where policy is and where it should be has several causes. One is a legacy of policy disinterest in the sector, a rather natural result of its absence from the main models used to help design economic policy and of the weak organisation, political voice and bargaining power of the sector. In those numerous countries confronted with macroeconomic crises or strains, this unfortunate legacy has often been compounded by the heavy, sometimes overwhelming, focus on things macroeconomic to the exclusion of sectoral questions—understandable enough but nonetheless something which requires rectification. Design and implementation of good SME policy is rendered difficult by the fact that it involves a variety of different branches and levels of government and by the fact that much of the information which would help to refine such policy is not yet readily available in most countries, most certainly including Pakistan. Now a new complication must be added; whereas previously the contribution a country could hope for from its SME sector was primarily related to production for protected domestic markets, now it increasingly involves competition in the international market. Much of what might have been useful policy support before may be less so now; in short both the role of the SME sector and the optimal policy to get the most out of it must be rethought in the new context of market integration.

The special role/task of SME in the creation of productive employment relates to its position in the middle of the spectrum of sizes and capital intensities in a developing economy. Each sector of an economy has a demand for labour of each type. As a first approximation to the real world one may focus on just one type, the relatively unskilled. On average, the labour demand curves of larger, more modern firms start higher than those of smaller, less modern firms but are also less elastic. This reflects the fact that in firms using modern technology the productivity of labour is quite high for the few

workers required to complement a given amount of capital (hence the curve starts high) but since only a few workers are needed it falls steeply. Such firms can pay a few workers quite well but are not interested in hiring very many. At the other end of the spectrum is the microenterprise sector which has a flatter demand curve for labour—the curve starts low since not even for a very small labour input is the productivity very high. In Figure 1, the labour demand curves of large enterprise (LE), small and medium enterprise (SME) and microenterprise (ME) are portrayed as curves LL', SMSM', and MM' respectively. The total demand curve (TABT') for labour is the horizontal summation of these three curves. Most of the potential employers at very high wages on this total demand curve are modern firms, the bulk of the middle of the TABT' curve corresponds to the demand of SMEs, and the majority of the bottom of it to quite small, low technology microenterprises. Were there enough of the complementary factors (capital, natural resources) to generate a TT' curve far enough to the northeast in the figure to cut the labour supply curve (SS') at a high wage this would of course be desirable; this is the situation in developed countries. In developing countries, the availability of complementary factors is too limited and hence the size of the modern sector too small for this outcome to emerge. Under these conditions, a country which allocates a high share of capital to the very modern sector is likely to have the majority of the population working with very little capital and hence low labour productivity (demand for labour); curve TCT'' could represent the demand curve for labour in such a case. The equilibrium wage would be quite low; workers in the modern sector would probably be able to bargain away some of the profits in that sector through labour legislation or collective bargaining. Another economy endowed with the same amount of capital/other non-labour resources (and the same number of workers) but which allocated more of the capital to the SME sector rather than the LE sector, would be expected to have a labour demand curve which was lower for small quantities of labour (i.e. at points closer to the vertical axis) but higher for large amounts of labour; it would therefore normally have a higher equilibrium wage, though perhaps less very high wages (since there would be less chance by favoured workers to bid away some of the very high profits of favoured sectors). In either type of situation there will be some employment complemented by very little capital and hence generating very little output or labour income; this corresponds to the rightward portion of the demand curve. In most cases the lowest part of the demand curve is in effect a demand for own-labour on the part of low income self-employed people. The paid wage rate for hired workers in LE and in SME will be higher than these individuals can generate as own income.

Note that the more basic distinction being made in the above discussion relates to level of firms' technology and productivity rather than their size; a country endowed with a medium level of resources per person needs to have a large amount of those resources utilised with medium level technologies, unless it wants to have a very

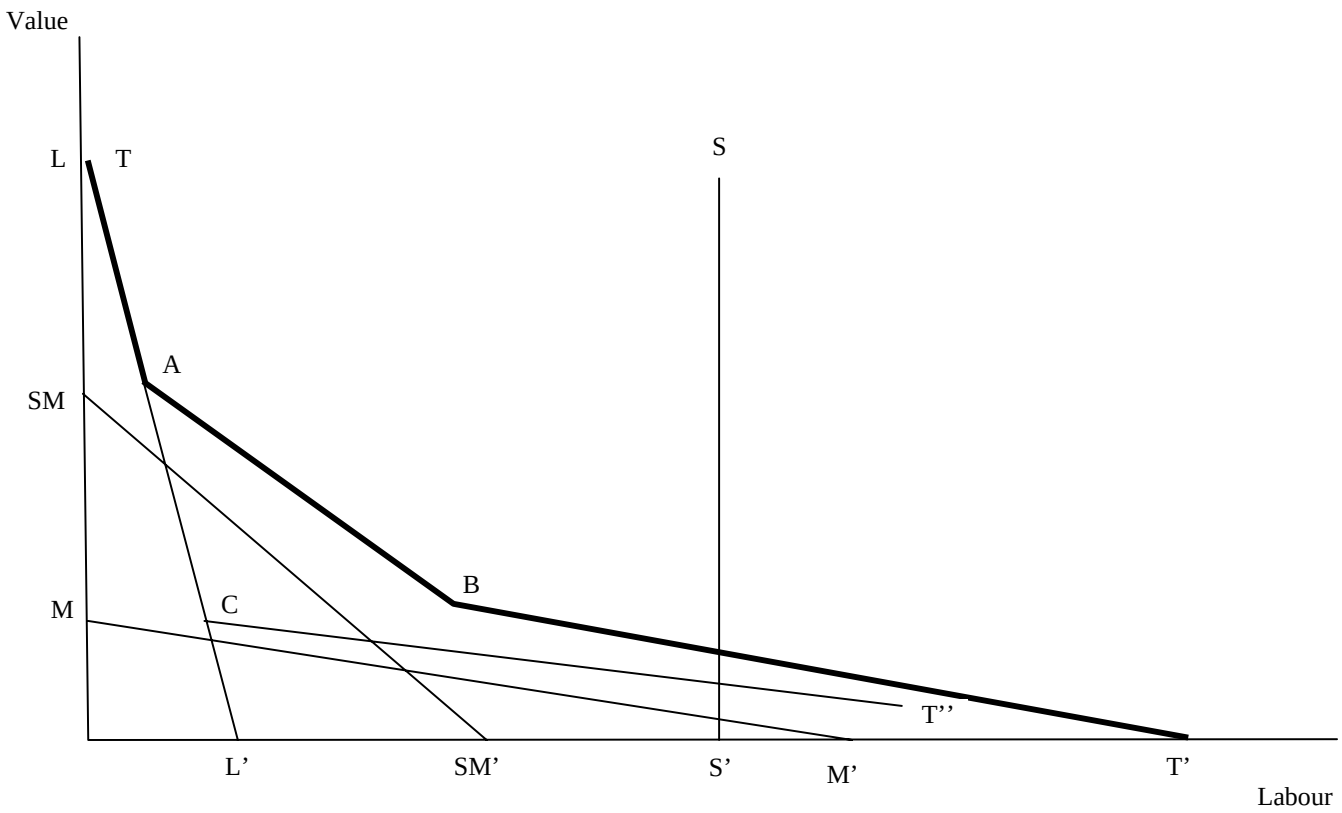

Fig. 1.

unequal distribution of labour across the available capital, with a few workers able to achieve very high productivity because they work with a lot of capital and the rest able to attain no more than a very low productivity because they are starved of capital. Since, with a few exceptions, size of enterprise is rather closely correlated with level of technology, this boils down to saying that such a country should normally have a lot of SMEs, since if it allocates too much capital to LE there will be much labour left over with little capital to complement it and this mass of resources will be mainly in very low productivity microenterprise. In some developing countries large firms seem to be able to operate without excessively modern technology, but this is unusual.

With starting conditions like those portrayed in the figure, healthy growth, whose fruits are reasonably well distributed among the population, depends very substantially on the SME sector and on the microenterprise sector (the latter interpreted to include the bulk of agricultural families who have very small plots of land). The LE sector, if efficient and productive (and this is a big "if" in most countries) can contribute significantly to output growth but only very modestly to employment growth—and probably not at all for some time to come in many countries where trade liberalisation will cut employment in some important subsectors; it can also contribute through efficient linkages with SME which operate to the mutual benefit of both sectors. But any hope for widespread benefits from growth will depend on what happens in the other two sectors. Alleviation of poverty can be conceived as a process involving two main mechanisms: the "shifting" of employment share from the microenterprise (low productivity) sector to the (middle productivity) SME sector, and the raising of productivity in the remaining microenterprise sector. Productivity in the lowest productivity subsector determines the opportunity cost of labour to the other sectors and hence sets a floor on earnings. Wages of workers (without capital) in the SME and LE sectors will get only that microenterprise productivity level in countries where the labour market is "undistorted" by minimum wages, unions, etc. In most cases some of the rents in those two sectors will be shared with workers, leading to wage differentials across the three sectors, and possibly also repressing the employment levels in them. In any case, poverty will only be eradicated when productivity of the lowest productivity sector rises above the poverty line.

To consider further the role which SME could play in future job creation, it is useful to distinguish the labour demand associated with each of five separate sectors of the economy, rather than just the three size-based categories mentioned above. Agriculture, while still important in most countries, has been and will continue to lose relative importance as a source of employment, even though in a few cases the economic liberalisation should have the effect of temporarily reversing this natural process. On average it is unrealistic to expect this sector to create large amounts of very remunerative employment. Two other important components of the economy are also unlikely to generate much employment in the short or medium run. The public sector is

in most countries under a fiscal constraint which impedes employment expansion. The large-scale private sector producing tradables should generate significant employment growth in a few countries, but downsizing has been the more normal accompaniment of liberalisation thus far, as firms struggle to raise productivity and competitiveness while introducing labour saving machinery and equipment. It thus appears prudent to assume that employment may be close to stagnant for a while in this sector before its normal growth resumes. The rest of the private sector can be disaggregated into the SME segment and the very small firm (microenteprise) segment. Microenterprise plays the very important insurance role of providing a minimum, albeit quite low, level of income to many people, but it does not have the capacity to generate moderate to high incomes for a large number of people. This leaves SME as the sector which does not require very large amounts of capital to grow and which, also, should be able to produce good levels of income for many people.

2. THE KEY QUESTION: HOW LARGE A ROLE CAN SME PLAY?

The above discussion reflects a straightforward logic which suggests that an economy's performance will be better both in terms of output and of income distribution and employment generation if it focuses a sizeable share of its resources on technologies of middle-level capital intensity, rather than allocating a high share of the capital to a few workers employing quite modern technologies and almost none to the rest of the labour force. The SME sector's contribution to economic performance could in principle be improved either by raising the internal efficiency of the resources already employed within it or by increasing the share of the economy's resources employed by it. The important question is how much difference such changes could make in quantitative terms.

Focusing on the trade-off between use of resources in SME and in other ways gives a static efficiency perspective. But dynamics are equally or more important, including both the implications of the size of the SME sector for savings, investment and technological change—what we may call the growth implications, and also the dynamics of adjustment when an attempt is made to reshuffle the structure of the economy (by size in this case) with a view to raising its efficiency.

Recent literature from virtually all parts of the world emphasises the important contribution which SMEs can make to an economy's strong overall performance, whether it be the United Sates [Audretsch (1998)], Japan [Urata and Kawai (1998)], Developing East Asia [Berry and Mazumdar (1991)], Africa, or Latin America. For the most part the increasingly positive reassessment of that role owes itself to a combination of a better understanding of the static economics of SMEs, a better recognition of the scope of SMEs in economies and a more careful thinking through of the role of firm

dynamics in economic structure and performance. Perhaps most important has been the empirical evidence that some of the world's best performing economies, notably Taiwan and Hong Kong, are very heavily based on small enterprises. A few experiences from countries elsewhere confirm that the SME sector can be a major source of dynamism, as in the case of Colombian manufacturing from the late 1960s to the early 1980s [Cortes *et al.* (1987)].

Most of the especially successful economies where SME has played a demonstrably large role have also been outward-oriented East Asian countries. These countries have been very successful at hooking the SMEs into the export process, through some combination of direct exporting by smaller firms (often through relatively small intermediary agents, as in the case of Taiwan) or through subcontracting by SMEs with bigger firms, as in Japan over a long period and Korea with increasing intensity since the mid-1970s. This record of achievement under export orientation is particularly attractive to the countries of Latin America at present, given the challenge to succeed in a more open context and to do so on both the growth and the distribution fronts.

Total factor productivity (TFP) analyses have been carried out on occasion in developing countries, both to assess the relative efficiency of different branches of industry, different sizes, etc., and to measure the change in such efficiency over time. The literature does not point to any consensus conclusions on the relationship between size and productivity. Many studies do not include sufficiently accurate measurement of inputs to provide much confidence in any conclusions towards which they might point. A good number of studies have reported rising TFP by size. Many others have found TFP peaking somewhere in the middle of the size distribution, usually within the SME range.[1] Almost none of these can boast very satisfactory measurement within the microenterprise and SME size range. The most careful set of studies in terms of measurement, carried out under the guidance of Liedholm and Mead at Michigan State University, come to a different conclusion, finding that TFP is typically a declining function of size once the unit gets to the range of a few workers (but above the single person plant).[2] Though most of these studies have been undertaken in African countries (along with the Dominican Republic and Jamaica) and have focused mainly on the lower end of the size range, the contrast between their findings and those of the many other studies which report lower TFPs for smaller firms than for either medium or large ones (regardless of which of the latter two comes out better) does raise serious doubts about the validity of those other studies, which tend to suffer from measurement problems ranging from fairly to very serious.

Since many smaller firms are also young, any assessment of the economic potential and contribution of SME should take account of firms' life trajectories, not

[1]Little, Mazumdar and Page (1987) in their review of literature consider this to be a relatively frequent outcome.

[2]Communication from Carl Liedholm.

just their point of time status. Rates of entry and exit are higher for smaller establishments than for larger ones,[3] so in this respect as in many others, SME is the middle of the spectrum between microenterprise and large enterprise. Many young small firms do not survive, and that there is some loss of societal resources in that process of failed attempts, though the great majority of the lost resources are those of the entrepreneur himself/herself. Those firms which do survive for a few years and typically grow to a small (as opposed to very small) size, are, according to the Michigan State studies already quite efficient from a static point of view. In addition, however, many of them are in a position to grow further, to contribute to the process of accumulation of resources, and often to innovate technologically, in terms of management, etc. Most large firms began their life as relatively small ones, so the contribution of SMEs in the early years of their history is in that sense inextricably linked to the larger firms of a few years farther on. In an overall assessment of the role of SME in an economy, the considerable rate of turnover which characterises even the small-medium sized firms in most economies does not appear to have any clear-cut implications for the sector's usefulness to the economy.

3. THE ECONOMIC CONTEXT OF SMEs

Before considering how public policy may encourage a strong performance from SMEs, it is necessary to have a reasonable understanding of their setting and hence of their problems and needs. Like other firms, SMEs exist in networks of suppliers, buyers and competitors. More than larger firms, which at least have the option of handling many of their needs in-house, SMEs rely on other firms or institutions for their inputs, for the training of their workers, often for help with their marketing needs, and so on. One can distinguish three broad groups of SMEs according to the nature of their relationships with other firms: those which are subcontractors (usually but not always with larger firms); those which are members of "clusters" made up mainly of small firms; and those which are more or less independent, in that they fall in neither of the above two categories. Its needs vary considerably according to which of these groups an SME falls into or closest to. Subcontractors can receive considerable help from the contractors with which they do business; members of clusters tend to satisfy a number of their needs by collective action—e.g. in the areas of marketing, technical assistance, training of workers, purchase of some inputs, and so on. Independent firms are, as the term implies, more dependent on themselves.

Many needs are common regardless of setting. Firms must achieve a certain level of efficiency either to have success as independents or to qualify as candidates for either of the other two arrangements. Contractors are not willing to invest their time or efforts with subcontractors which are not close to being efficient producers. And a cluster must

[3]A particularly detailed study is that of Aw *et al.* (1997) on Taiwan.

have a high level of collective efficiency if it is to compete in world markets, as many of the most effective clusters do. At present, interesting efforts are being made in various developing countries (e.g. Brazil) to facilitate large-small firm links, to develop denser subcontracting systems and to foster effective collective action among SMEs in areas like exporting, purchase of inputs, etc. These developments are encouraging and indicative of creativity; some of them will probably provide interesting models which can be generalised.

Regardless of the context in which an SME finds itself, it is increasingly likely that its success will depend on ability to participate effectively in international trade, either as direct or indirect exporter or as successful competitor with imports. It is thus important to consider what policies help SMEs to achieve success of this sort.

4. POLICY VS. EXOGENOUS FACTORS IN THE PERFORMANCE OF SMEs

What hope is there that SMEs, even if the entrepreneurs are ready and willing, can succeed in an increasingly competitive world? The answer is "considerable", especially if policy is supportive and effective. The increasing prevalence of flexible specialisation has persuaded many analysts that smaller firms will play an increasing role in the industrial structures of the future. The major role of SMEs in employment creation in Canada, the U.S.A. and a number of European countries over the last couple of decades appears to support this view [Audretsch (1998)]. Closer to home in terms of economic structure and level are the experiences of several of the East Asian countries, especially Japan, Taiwan and Korea. Japan has been and remains the prototype of the economy in which the SME sector plays a major role, principally via subcontracting with large firms, which tend to be engaged in international trade. Taiwan is the prototype in which the SME sector plays a pivotal role by itself, without the high level of dependence on large firms which characterises the Japanese model. Many students of Taiwan's experience believe that its outstanding success in achieving both dramatically fast growth and perhaps the lowest level of inequality of any developing market economy are substantially attributable to this dominant SME role [Fei, Kwo and Ranis (1979)].

Although it is hard to be very precise quantitatively, the evidence alluded to above does suggest that the SME sector can loom large and important in an economy and that when it does so both the growth and the income distribution performances can benefit greatly. There remains however the biggest question of all—to what extent does such impressive success owe itself to exogenous factors like a wealth of entrepreneurial talent, a culture which favours the business characteristics that are friendly to the development of SMEs, a topography conducive to a dense network of small firms, or a history which did not produce a lot of large firms? In other words, how much of the

experience of a country like Taiwan is plain luck, and hence could not be repeated even by the most astute and well executed policy in some other country that did not share the same institutional or other features which helped it down that particular road.

There has been a good deal of scepticism in many developing countries as to whether, given their different institutional and cultural backgrounds from those of the better known success stories, could achieve such success. This scepticism needs to be taken seriously, yet not overdrawn. And it is true that any judgements as to the impact of policy must be qualified, since there are few experiences which provide good tests of what a concerted and well-organised attempt to support strong SME growth can do. But the experience of Korea since the mid-1970s is at least close to being such a test, and the lessons it suggests are interesting and encouraging. As of the early 1970s its industrial structure was more similar to that of countries like Brazil, Mexico, Indonesia, and probably Pakistan than to that of Taiwan, at least in the sense of its being dominated by large, vertically integrated firms which did relatively little subcontracting, and in that the SME sector was accordingly much less important than in Taiwan or Japan. Since that time however, Korea's SME output and employment growth has been very fast indeed, such that its share of those two variables in the manufacturing sector has risen rapidly [Cho (1995)]. At the same time the level of inequality in the country has diminished. Most of the SME growth has been due to a rapid increase in the density of subcontracting, i.e., to a move towards of the Japanese model of industrial structure. This experience is relevant to Pakistan; it suggests that in economies with some structural similarity to Pakistan's, a rapid increase in the role of SME can be achieved when conditions are right. In the Korean case the sharp shift of structure was due in part to an increase in competitive pressures associated with the appreciation of the yen in the mid-1970s and of the won with it, and to a concerted effort through public policy to expand the role of SMEs. Both these conditions could be approximated in Pakistan. The partial opening to international trade will have an effect somewhat parallel to the appreciation of the Korean currency; probably the modest level of subcontracting by larger Pakistani firms has been in part a product of the high levels of protection. The second condition, a well designed and vigorous set of policy supports is at the disposal of these countries if they take up the challenge seriously enough. A well-designed policy package is not expensive, but it does require a level of serious dedication which has been for the most part absent in the past.

It is important to recognise the potentially great difference between success and failure in integrating SMEs directly and indirectly into the world economy. Potential failure is implicit in the fact that integration with the world economy can be a daunting prospect for small firms, and a quick reduction of import barriers can decimate some SME sectors, especially when the real exchange rate is allowed to fluctuate, creating periodic waves of imports. Although SMEs often live by their flexibility and agility, many of them are at the same time vulnerable to major external shocks. One of the

challenges to effective support policy is an understanding of this fact and its implications in a given country. But success has been achieved both by whole countries like those mentioned from East Asia and, around the developing world, by internationally competitive clusters of firms from various countries as well as by competitive industries which draw some of their strength from a considerable amount of subcontracting.

5. THE CURRENT SETTING IN PAKISTAN

After a creditable growth record over much of the period since 1947, Pakistan has stumbled in the 1990s, with growth falling to an average of 3.75 percent over 1992-97. With population growth still growing at a rapid 2.65 percent per year, per capita output was rising at just over 1 percent per year. Together with the well-known fiscal challenge and the need to raise the domestic savings rate if the macroeconomic requisites of fast growth are to be in place, Pakistan also faces a severe employment challenge of assure that the approximately one million annual increase in the labour force will be matched by decently remunerative jobs, the failure in which can easily translate into an income distribution crisis.[4]

As noted above, a five-sector disaggregation of where new jobs will or should come from provides insights into severity of the possible employment/distribution challenge and how the SME sector fits into it. Good job opportunities should be sought in all of these sectors, but realism suggests that even when this is done, several will be unable to contribute many net new jobs with decent earnings levels attached to them. Agriculture still provides 45–50 percent of employment in Pakistan; the share of new jobs provided over the last couple of decades appears to have been in the range 30–40 percent[5] with this share naturally expected to fall over time unless the economy is in severe difficulties. It is inevitable that, if the present trends in the absolute level of agricultural employment continue, many of the new jobs will be of low productivity, making it desirable that other sectors shoulder a bigger share of the job creation task. Though the public sector may continue to create some net employment, the fiscal situation makes it imprudent to expect much form it. Microenterprise can provide a sizeable number of relatively low income jobs and should be encouraged and assisted in doing so, but its potential to expand quickly without a significant decline in the income levels generated is very limited. This leaves only the large scale private non-agricultural sector and SME. The former, while it will hopefully create many jobs eventually, will

[4]Income distribution and poverty estimates come with long lags in Pakistan, which complicates the assessment of current trends. But it is worrisome that, with per capita income still growing fairly strongly over the period 1987-88, Amjad and Kemal (1997) estimate the incidence of poverty to have risen from 17.3 percent to 22.4 percent. It is possible that the 1987-88 figure was an anomaly, since it was far below the 1984-85 figure of 24.5 percent.

[5]Given the jumpiness of the figures on the share of employment in agriculture, the rate of downtrend depends on the precise period over which the calculation is made.

probably not contribute much in the short run. As of the early 1990s, it probably accounted for around 5 percent of all employment.[6] And, under the influence of increasingly open economies this sector is likely to see a good deal of downsizing, raising of labour productivity to increase competitiveness, etc. Necessary as this may be, it does nothing for employment creation. Unlike the large firm sector, SMEs can create a good deal of employment with a modest amount of capital. The success in some segments of this sector, including the clusters mentioned above, suggest that the supply of entrepreneurial talent for SMEs may be reasonably adequate, if properly complemented by collectively provided services. In short, the SME sector is strategically placed to make a major contribution to the overall successful performance of the Pakistani economy over the next decade or so, at least.

Although formal sector data on Pakistani manufacturing (based on the annual manufacturing establishments survey) report that only a small share of reported employment is located in the SME sector,[7] the microenterprise sector is quite large and the SME sector is probably somewhat, perhaps considerably, bigger than the data suggest.[8] In any case the small size of the formal sector, both in manufacturing and in overall employment, makes it clear that it will not be dominating the employment structure of Pakistan for many years to come. If the country is to achieve broad-based healthy and rapid growth, this is likely to be based on agriculture and on rural and urban small enterprise, with medium enterprise playing a modest role in the beginning but one which increases with time. It is very important that rural non-agricultural activities expand both in numbers and in productivity. Successful growth experiences of countries from Pakistan's current level typically involve a strong symbiosis between growing agriculture and complementary rural non-agricultural activities, including those which involve trade and processing of agricultural raw materials and those which produce and trade consumer goods for the rural population, and those rural clusters which are specialised in goods for sale elsewhere in the country.[9] Data are not available for Pakistan on the relative importance of rural clusters in rural manufacturing and overall non-agricultural activity, but judging from that for a number of other countries plus case studies and anecdotal evidence for Pakistan this sort of activity may be

[6]The labour force survey of 1993-94 indicates that the whole formal sector, including the public sector and formal private sector employment accounted for only 10 percent of all employment [Irfan (1997)]. Whatever the precise distribution between the public and private components, it is clear that both of them are small.

[7]As of 1990-91 over three quarters of the 617 thousand workers recorded were in large industry (defined as establishments with 100 workers or more).

[8]Comparison of the manufacturing survey data with those of the household surveys imply that only about one sixth of all manufacturing employment is caught in the former, and hence that the great majority is in the informal or microenterprise sector. Probably a fair share of SME establishments towards the lower end of that size range are missed in the annual manufacturing survey.

[9]This has been very much the experience (until the recent crisis) in Indonesia, where rural incomes have risen rather rapidly and the benefits appear to have been relatively well distributed.

substantial. Evidence from other countries also is encouraging with respect to the potential of such clusters for raising productivity, especially those which sell to outside markets.[10] Given the present and likely future scope of rural non-agricultural activity, it would be a major contribution to growth with equity if enough of the currently quite small enterprises could growth into SMEs with significantly higher productivity. The key to rapid increases in the income of families whose current base is in agriculture will be an increasing income form such rural non-agricultural activities, if we may judge by the experiences of most other countries, developed and developing.

Not only is the large scale private sector so small that it would be hard for it to achieve a growth rate which would contribute much to employment expansion, but much of it is in any case of doubtful economic efficiency. Increasing competition will lay such inefficiency bare, with some firms having to close and others surviving by scaling down their labour forces. Eventually large enterprise should and hopefully will constitute a major share of the country's employment, but most of those firms will probably have grown out of today's SMEs. This pattern tends to be true even in developed countries with already extensive LI sectors. It is the more true in a country like Pakistan, whose LI sector is currently small and much of it inefficient and therefore subject to dismantling.

There are enough examples of effective groups of clustered SMI in Pakistan (surgical instruments, rubber balls, etc.) to provide assurance that such experiences can and should be become more general. For such an expansion it will be important that local entrepreneurship be encouraged and complemented by public policies. As elaborated in studies undertaken as part of the *Pakistan 2010: Long Term Perspective Study* [see the citations under DRI/McGraw-Hill (1998)], such policies include a major strengthening of the "national innovation system" through attention to the R&D institutions and to the participation of the private sector in the process of distribution of public funds for innovation [DRI/McGraw-Hill (1998 and 1998a)]. Though much effort would be requited to multiply the success stories of this sort, the presence of several impressive successes together with an underutilised R&D and entrepreneurial capacity[11] bodes well for the future if such an effort is made.

6. WHICH POLICIES HELP THE MOST TO INDUCE A STRONG PERFORMANCE FROM SMEs?

The SME sector is a very heterogeneous one, so it should not be expected that the same policy package would be optimal across branches, across countries at different levels of development, between SMEs which are subcontractors and those which are

[10]Referring again to the case of Indonesia, see Sandee (1995).

[11]Pakistan has lost a considerable number of professionals through emigration who would probably stay in the country if opportunities were better. Many of their counterparts in countries like Taiwan, Korea, Malaysia, Brazil and other countries of Latin America are engaged in SMEs.

part of clusters, producers of tradables vs producers of non-tradables, etc. It must also be recognised that in some areas our understanding of what good policy may be remains incomplete for lack of policy experiments and careful analysis. These caveats aside, a number of important conclusions are now possible.

First, it is necessary to recognise that Pakistan is at present seriously lagging in the overall quality of its support systems for SMEs. The fact that an effective system involves participation from diverse branches of government and from private collective institutions which are not yet strong in Pakistan imposes a real challenge to the quick development of strong systems. In the well functioning systems around the world (of which Taiwan and now Korea are examples) there is generally good coordination among the purveyors of different services and the institutions which help to determine the context for SME performance.

One of the probable reasons for the presence of successful clusters of SMEs in countries where overall SME development is not particularly successful lies in the fact that the needed degree of coordination among the elements of a good policy package is often easier to achieve at the local than the national level. At the national level, policy-making is currently most often dominated by macro concerns and macroeconomic specialists (in the Central Bank, the Ministry of Finance, etc.). With the increasing specialisation over the years among the branches of economics, this has meant that those in charge of the main levers of policy are unfamiliar with the varying situations and needs of specific groups of firms defined by sector or, as in the case of SMEs, by size. For informed, effective policy at the national level this hurdle must somehow be overcome. More complete knowledge among the decision-makers would help; so would the more frequent presence of representatives of the SME sector at the policy-making table. In most countries their political voice is muted; in the great SME success stories like Taiwan it is strong. At the local level neither the macroeconomic bias of decision-makers nor the absence of SME voice is such a problem, and there are the added advantages that the various firms and local policy-makers tend to share a desire to see the region succeed, and that their personal acquaintance makes collaboration easier.

One policy which matters to more and more SMEs as economic integration proceeds is exchange rate management.[12] Although SMEs show various types of flexibility and agility—in fact this is often what keeps the survivors afloat, they can be quite vulnerable to certain types of external shocks; in general they are more so than their larger counterparts, which typically have the reserves (economic and political) to weather storms, and are often more diversified to start with, rendering them less vulnerable to what happens in special small sectors of the market. In the present era, with its inflows and outflows of hot money putting pressure (in one direction or the other) on the exchange rate, the risk of damage or death to essentially healthy SMEs

[12]Colombian SME exporters reported that it was one of the policy areas of greatest concern to them [Levy *et al.* (1999)].

(healthy in the sense of their having the potential to be economically productive over a lengthy period) is high.

Most of the other key policies in support of SMEs are more microeconomic in character. Most have as their objective helping these firms to be more efficient and competitive (while at the same time creating relatively good-income jobs). Many simultaneously increase a firm's performance capability and also increase the likelihood that it will be able to enter a useful subcontracting relationship with a large firm or be a productive member of a cluster. Large firms are only interested in subcontracting work out to smaller firms at or above a minimum performance level.

Marketing success constitutes one of the key challenges for many SMEs. A valuable experience for SMEs in many industries is participation in trade fairs—at home and/or abroad, the latter of which can be a good means of penetrating export markets.[13] (Trade fairs also turn out to be an important source of technological learning.) More generally, however, governments' institutional capability to deliver marketing support is weak in most developing countries. The developing world is littered with failed export support programmes and 'white elephant' export institutions. A better approach is intervention with a "light touch" that provides firms with the wherewithal to find buyers for themselves, rather than attempting to substitute for efforts by putative exporters. Export marketing support should also be decentralised and tailored to the specific realities of individual marketplaces so as to be able to respond to the enormous diversity of players and market mechanisms across subsectors. The experience in Colombia exemplifies. The performance of the national export agency, PROEXPO (created in 1967), in providing direct marketing support to SMEs has been less than impressive, judging by the fact that relatively few of the Colombian SME exporters which used collective support reported that it came from PROEXPO.[14] The industry associations, by contrast, show considerable promise in this area, especially those in the leather and (more recently) garments industries. Working closely with their member firms, they have been developing the sort of sector-specific knowledge and skills which cannot realistically be expected from general purpose agencies like PROEXPO. A successful hybrid arrangement which is beginning to take hold is for PROEXPO and other public sector agencies to work collaboratively with industry associations—with the public agencies providing some funding to help organise fairs and assist visits abroad by potential exporters.

Technology upgrading is key to the continuing success of SMEs, especially those which produce tradables. In general, private rather than collective mechanisms are

[13]Exporting SMEs surveyed in Colombia, Korea and Indonesia reported fairs as the leading or second most valued collective source of export marketing support in seven of the nine subsectors studied by Levy *et al.* (1999, 6–9).

[14]Although one should note that its primary focus has been on the provision of credit for exporters, an activity which it apparently has undertaken impressively.

the main external (to the firm) sources of technological capability. In Japan, strong vertical and horizontal inter-firm relations drive the technology acquisition process, and such links are important in many other countries even if less dense than in Japan. Where such helpful private-sector links are limited, the challenge of technological acquisition is a formidable one, and the consequence can be technological isolation and resort to ad hoc learning. Yet a number of experiences from outside the region (such as that of Korea's engineering-based SMEs) and within it (various industries in Brazil and Argentina, Colombia's craft-based leather and garment SMEs, Chile's wood-processing) suggest that it is possible to successfully surmount this challenge via activist strategies at both the firm and collective levels.

Collective technical support can be "broad-based", contributing to the emergence of an "information-rich" environment, or it can promote "high-intensity" technological learning by supplying technical inputs directly to firms. The former works to enhance the overall availability of usable information, leaving firms to judge what information sources might be most useful, and how they might be adapted to a firm's specific needs. It involves things like sponsoring courses on specialised topics; facilitating the use of specialised consultants to a range of firms; and promoting information-sharing among firms. Such support appears to be useful in most countries of Latin America.

Broad-based collective support has been most effectively delivered by decentralised institutions—either by industry associations, independent non-governmental organisations, or by local governments in specialised industrial districts. The record of centralised institutions in delivering services is more uneven. The desirability of decentralised delivery reflects the wide diversity across activities in the kind of information that is useful, and consequently the need for delivery of broad-based collective technical support that is close to—and appropriate for—reasonably homogenous client groups.[15]

The goal of high-intensity collective support is to meet those specific technological needs of firms which are not adequately addressed through other channels. Demand for support along these lines is likely to emerge only at relatively high levels of technological complexity. For countries that lack an overall record of strong performance by parastatals, an effort to establish a high-intensity network of collective technical support, say along the lines of Korea's successful system, would appear to be risky. Where assistance is provided collectively, it often makes sense to do so to groups of clients. Chile has taken the approach of subsidising privately supplied technical assistance. Sharing of the cost with the client is clearly appropriate; the risk associated with subsidised private supply is that ineffective service suppliers will be

[15]In Japan, technical centres under the umbrella of local governments are the primary providers of broad-based collective technical support. A further function of Japan's collective technical support system—difficult to measure but, by all accounts, very useful—is as a node in an information-rich network.

induced into existence. It remains to be seen how broad a supply of quality services will emerge in response to such a system.

The role of **access to credit** in the healthy evolution of the SME sector has been controversial, both with respect to the whether lack thereof is typically one of the major impediments and with respect to whether financial liberalisation is more likely to improve access or weaken it. The evidence is thus far ambiguous on both counts. There is little doubt that many SMEs could grow more efficiently with better access to credit, but it is less clear what are the limits to the likely performance of a financial system in terms of allocating such credit to the "right" borrowers. Perhaps the only valid generalisation is that a financial system will work better when it has better designed rules to guide lending to SMEs and more SME-specific personal expertise, that is, more people who have enough feel for the context of SMEs to be discerning lenders. Not too many institutions in Latin America or elsewhere in the developing world have performed impressively in this regard.

The impacts of financial liberalisation are a source of optimism to those who believe that the public-sector banks which focused on SMEs were ineffective and that the private sector could do a better job, especially when interest rates were brought closer to equilibrium levels so that credit allocation would more likely be guided by which sectors had a strong effective demand for credit. Research by Jaramillo *et al.* on Ecuador led them to conclude that the process improved the access of smaller firms to private sources of credit. Survey evidence reported by Levy *et al.* (1999) for Colombia (and Indonesia) indicated that smaller and generally less well placed SMEs relied more heavily on public sector banks while their better placed counterparts draw more on the private banks.[16] It seems likely that the access of small and otherwise disadvantaged SMEs to external sources of finance, and especially to bank loans, depends heavily on the degree of development of the financial markets; in countries like Japan it is relatively good while in most Latin American countries it is considerably less so.

Another significant difference between better financial systems and weaker ones involves the performance of credit guarantee systems. Such systems work relatively smoothly in Japan, in part because it is primarily operated by local associations (which naturally have better information than outsiders on the reliability and credit-worthiness of various possible borrowers in their geographic area), and in Korea where, because the guarantees are only partial, banks have considerable incentive to be careful both in their credit evaluations and in credit collection. In both these countries default rates have been kept to manageable levels. By contrast, and especially in their early stages, several of the Latin American schemes (e.g. that of Colombia) have suffered major incentive and other problems, producing high rates of loan default, often accompanied

[16]A similar tendency for collective technical support to be more highly valued by "marginal" firms seems to be typical.

by long delays by the guarantee system in compensating the banks making the defaulted loans. As a result, lending institutions have often become leery of extending credit to SMEs except where strict collateral requirements could be satisfied, more often the case with the larger and better-endowed SMEs. The insistence on collateral, even when the loans are guaranteed, tends to defeat the purpose of the guarantee system.

Support for appropriate **education and training** is another important element of an effective support system for SMEs. It is often notable that training institutions play a significant role in the development of such SME clusters as Novo Hamburgo in Southern Brazil [Schmitz (1995)] and Rafaela in Argentina [Quintar *et al.* (1993)]. SMEs do not and cannot be expected to supply most of the needed learning in-house, both for lack of resources and out of fear of "poaching" by other firms. Most of Latin America's vocational training institutions and systems were originally designed to take care of the needs of larger firms. Increasingly it is recognised that their efforts should now be mainly focused on SMEs [Berry and Mendez (1998)]. Encouragement of SME suppliers through public sector purchasing may also play a role, as in the Ceará programme (as described by Tendler (1997), Chapter 5).

Several types of support are directed to improving inter-firm cooperation involving SMEs (either among themselves or with larger firms) or to take advantage of economies of scale available by providing services jointly to many SMEs;

(i) support for relevant business associations—sometimes umbrella SME associations, sometimes industry-specific ones, often local ones;
(ii) practically oriented support for large-small linkages, e.g. along the lines of the SEBRAE programme in Brazil [Marx (1993), cited by Humphrey and Schmitz (1995), 19];
(iii) SME network support programmes, of which the Danish Network Cooperation Programme and Chile's PROFOs are good examples [Berry (1997)];
(iv) subcontracting exchanges; though it is not clear whether they will often have a large payoff, their modest costs makes them a logical component.

With respect to how to carry out SME support policies, two points deserve comment. First, support should be provided on a group basis where feasible, in order to increase the chances of inter-firm cooperation. Second, the modus operandi of support systems and their components should usually be one-shot or time-limited when possible in order to avoid the creation of permanent bureaucracies, at least until the benefits have been shown to be clearly satisfactory. Thus, for example, subsidies for participation in any given network should normally be time-limited.

To backstop effective SME policy it is essential that information on the SME sector be collected, organised, and analysed so that policy decisions no longer be taken on the basis of partial and mainly anecdotal understanding of the characteristics and needs of SMEs. Related to this is an urgent need for serious monitoring of the

programmes which are put into place; many programmes will of necessity have an experimental character for the time being since so little is known about which instruments work well in which situations.

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