

# Theories in relation to the sme sector literature review



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The last chapter provided a brief explanation on the research area and its application for the economy of Pakistan. But the research needs to be further elaborated with the help of decent literature examination. This chapter undertakes the task of analysing different theories in relation to SME sector around the globe and provides a thorough understanding of dynamics involved in the growth of the SME sector.

## **2. 1 Importance of SME sector in emerging economies**

There has been a general consensus of researchers on the importance of Small and Medium Enterprises (SMEs) for the growth of the economy. Asian development bank in their report “ SME Development in Pakistan” emphasize the key role of SMEs for the growth of the country. Moreover the role of SMEs in generating employment and ensuring equitable distribution of income is also acknowledged. Furthermore according to the Economic Survey Of Pakistan 2008-2009, there are 3. 2 million SMEs in Pakistan which constitute over 90 percent of all private enterprises in the industrial sector, employ nearly 78 percent of the non-agricultural labour force, and contribute over 30 percent to gross domestic product (GDP). SMEs are the growth engines of the economy due to their ability to create jobs, foster entrepreneurship, and provide depth to the industrial base of the economy (Ahmad, Nenova, & Niang, 2009). Moreover the state banks of Pakistan (SBP) in their report realize the significance of SMEs for social and economic development. Employment generation, poverty alleviation, accelerated growth, bridging the gulf of income inequity and formation of forward and backward linkages are special features of SME sector. That being said

evidence has to come from developing economies worldwide to understand the importance of the SME sector in emerging economies.

According to the report from SMEDA, during post world war II period, economies of the Asian region leveraged the potential of their SMEs for pursuing fast track industrial growth. Economies and industrial development of countries like Japan, Korea and Malaysia is attributed to their dynamic SME sector. The process of SME development gained strength in these countries from formulation of legal frameworks and enactment of laws facilitating SME growth and development. The lesson from the past highlights the fact that SMEs proved to be an important element for the pursuit of development for emerging economies. The reason explored for these are attributed to Asian development bank, there is a reason to believe that SMEs play an imperative role in structural transformation of the economy. An emerging economy requires a sound industrial base which would stimulate growth (Bari, Cheema, & Haque, 2005). Thus when SME concentration is high they provide employment and output in the initial phase of the transformation and assist in the transition itself. Hence while moving from a low-income country to middle-income economy SMEs provides important links through which the transition is smooth and fast track.

Although SME sector is favoured on the point of view that (i) SMEs stimulate economic growth, but (ii) market imperfections and institutional failures hamper their growth. Critics question the effectiveness of such measures and point to empirical evidence either in favour of large firms or of a size-blind policy approach (Thorsten, 2007). Ayyagari, Beck and Demirguc-Kunt (2003), were able to formulate a regression between SME and economic

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growth; the results did not reveal that SMEs do not promote economic growth. Rather, they fail to reject confidently the hypothesis that SMEs do not exert a causal impact on GDP per capita growth. Hence the findings were consistent with the examination that high concentration of SMEs is a prominent feature in fast-growing economies, but does not lead to rapid economic growth (Thorsten & Asli, 2006).

In most other countries of the world, SMEs represent the vast majority (99%), of all enterprises (OECD, 1998). The contribution of SMEs to economic growth, job creation and innovation has been widely recognised (ANITA, 2005). Especially because of being dynamically efficient within their sector and achieving high allocative efficiency from social point of view SMEs do play a vital role for the growth and development of emerging economies (Bari, Cheema, & Haque, 2005). Because of their importance for the developing economies it's vital to understand the elements which can stimulate the growth of SME sector.

## **2. 2 Agricultural Sector dependencies of SME sector**

## **2. 3 Indicators of assessing Sustainability of SME Sector**

The SME sector of the economy is often in the spot light because of being neglected as a stimulator of economic growth. But often the researchers fail to examine the capacity of SMEs to sustain the development which is promoted. The growth potential of SMEs has to be inspected through different indicators, to gauge an understanding on sustainability. The global economy has witnessed SME entering international trade market on a regular basis from last few years. Based on an empirical study of trends in 18

industrialized countries, the Organization for Economic Cooperation and Development (OECD) notes that SMEs now account for about a quarter of exports in most industrialized nations (OECD, 1997). Internationally-active SMEs are emerging in notably large numbers throughout the world, and they tend to be more dynamic and grow faster than strictly domestic firms (Bell, 1995; Nakamura, 1992; OECD, 1997; Rennie, 1993; United Nations, 1993). This means that as an indicator of SME sector sustainability we can examine the data on export contribution by SMEs, the higher their contribution towards export sector the greater their ability to sustain diverse economic conditions (Gary, 2001).

The economic survey of Pakistan and other international data vendors indicate the growth potential of the SMEs through value addition by the sector. It's noted that higher the value addition of SMEs towards the GDP, greater is their development prospectus. Furthermore reports from World Bank and ADB also consider Value Addition as an important indicator of sustainability of SME sector (Ahmad, Nenova, & Niang, 2009). The argument is, compared to large manufacturing sector SMEs can also be key for the growth of the economy and ones the sector is self sufficient and self sustaining than it will add value at a much higher rate towards GDP of the economy.

Most of the firm in the SME sector are labour intensive, which means employment rate can be utilized by the policy makers as an indicator of sustainability of the sector because human capital is vital for the survival of the sector. Most of the literature does incorporate employment statistics, while elaborating on the importance of the SME sector but most of them <https://assignbuster.com/theories-in-relation-to-the-sme-sector-literature-review/>

often fail to examine the characteristics of the entrepreneur/manager, the top management team and the board of directors in SMEs. Empirical findings have revealed the importance of owners and management strategic uplift of the business. And it is an important tool to understand the sustainability of the SMEs because a vibrant and pro-active management can help the growth of SMEs in unfavourable economic conditions (ANITA, 2005).

## **2. 4 Credit Information, Credit quality and Institution**

The financial institutes around the globe are extremely sceptical about providing credit in a situation where credit risk is high. The risk is intensified in the case of SMEs, who lack collateral, credit history and are unable to keep proper financial records. These demand side factors have led to, funding gap because SME cannot acquire credit from the formal institutions (Ahmad, Nenova, & Niang, 2009). Because of high risk and accelerating transaction cost for financial institutions, lending to SMEs is not a profitable option, especially when the probability of default is also very high (Thorsten, 2007). According to the survey conducted by ADB in 2005, most of the SMEs are of the view that financing constraints are most severe hurdle to cross (Bari, Cheema, & Haque, 2005). Along with a reluctant financial sector the problem is intensified and calls for proper reforms by the policy makers.

World-over, countries have developed alternative models to boost the fortunes of their SMEs through enhanced access to credit resources. There are risk mitigating mechanism like dedicated agencies for SME credit rating, credit information bureaus, credit registries, credit insurance and credit guarantee schemes etc. Some of them aim at increasing transparency and bringing objectivity in the assessment criteria for loaning, others involve

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intermediary institutions to share risk (Thorsten, 2007). Countries like Japan, Malaysia and Thailand have been using these mechanisms gainfully to lift and sustain their SMEs.

As a support initiative SBP introduced Credit information Bureau (CIB) in Pakistan in 1992, for keeping track of credit histories of both public and private enterprises. It was further enhanced with the introduction of E-CIB in 2006. The introduction of CIB has certainly affected the conservative mind sets of Pakistan banking sector (Ahmad, Nenova, & Niang, 2009). But there is still room for greater coverage by the CIB. The coverage should be extended to areas where SME concentration is high (SMEDA, 2009). The role played by IT and credit scoring are imperative and the responsibility of playing these roles lay on CIB. Empirical evidence does expose the fact that with the introduction of credit scoring models and institutions, the loan processing time for SME is reduced (Bari, Cheema, & Haque, 2005). Along with this loan disbursement policies are consistent across the banking sector which further promote SME lending.

Most of the researchers believe that introduction of Centralised data base like CIB can eliminate one of the chief alarm of elevated exploration cost of creditors for financial institutions. CIB can prove to be a useful support package for banks serving them in curtailing their hazards while expanding credit at the same time (State Bank of Pakistan, 2008). This might help to develop a framework through which access to finance for SME is originated. Through institution building policy makers can also make sure that customized products like cash flow based lending are endorsed while making an assessment of a client on basis of his credit history (Thorsten & Asli, <https://assignbuster.com/theories-in-relation-to-the-sme-sector-literature-review/>

2006). Another important element to realize is the fact that it's more important to have sound lending technologies than credit availability in the first place (Allen & Gregory, 2006). This is because credit does exist in an economy but only through proper channelling and technology the credit can be extended to SMEs. The research undertaken also provides evidence that with the help of proper institution dealing with aspects such as credit information and credit scoring the risk factor of banking sector can be minimized and confidence can be provided to extend loans to SMEs.

## **2. 5 Financial Institution, financial market Structure and SME prospects**

SMEs operate on a narrow capital base, those who have the urge to expand in terms of assets or sales turnover or aspire to augment quality, have limited options for financing for example, through retained profits and borrowing from informal sources i. e. friends/relatives etc. SMEs' access to formal credit, from commercial banks and leasing companies over the years has been insignificant. The case of Pakistan presents an important highlight. According to SMEDA, in 2006 out of the total credit off take of Rs. 2400. 8 billion for private sector, SMEs' share was Rs. 408. 3 billion or just 17% of the total amount. SME financing constraints are ranked on the top of the list of obstacles faced by the SMEs for growth (Thorsten, 2007). The availability of external sources of financing for SMEs has become an important area of research for policy makers around the globe (Allen & Gregory, 2006).

Analysis of the situation shows that there are issues on both the demand and supply sides. On supply side, banks shy away from lending to SMEs due to;

(i) highly risky sector because of its greater sensitivity to economic

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fluctuations; (ii) lack of collateral; (iii) lack of credible data on market size; (iv) creditors' high search cost; (v) high processing cost, etc. On demand side, SME industry cannot address concerns of banks due to; (i) smaller size; (ii) limited management capabilities; (vii) limited resources in keeping business account with banking requirements, etc. These concerns of both sides show that banks are risk averse and are reluctant to extend credit to SMEs while SMEs cannot afford meeting banking requirements (SBP, 2007). The supply and demand side factors are also acknowledged by the World Bank report as well as the Asian Development Bank reports. Along with these variables studies have also shown the role played by higher transaction cost and information asymmetric. Due to higher cost of dealing with small sized customer, which in this case are SMEs banks monitoring and processing cost is elevated (Chongwoo, 2006). This further hinders the flow of credit from the formal institutions towards SMEs.

It is evident from the findings of the literature that SME rather than turning to the formal sector for financing, prefer in-formal sources for financing such as loans obtained from family and friends. The fundamental reasons presented include collateral based lending from the banking sector, absence of suitable banking products aligned to SME needs, lack of awareness and access for SMEs and lack of risk mitigation strategies applied by the financial sector. This leads to the fundamental prospectus of modification in the financial sector. There has been much heated debate on the prospect of introducing reforms by the central banks of economies around the globe for greater access of credit at the disposal of the SMEs. It is imperative that beside the actual credit fund suitable lending technologies are created within

the financial sector for promoting banks to extend credit. Lending technologies are defined by most policy makers as unique combination of primary information sources, screening and underwriting policies/procedures, loan contracts structure, and monitoring strategies/mechanisms (Allen & Gregory, 2006). The affect of a nation's lending infrastructure has a profound impact upon the capacity of the formal institutions to provide credit to SME sector.

There has been extensive literature on the possibility of not using simple transaction based lending. The role of asset-based lending, leasing, and credit scoring, factoring, relationship lending and trade credit has been encouraged throughout the world. With the help of new advanced products which are tailored made for the SME sector, banks can prove to be an important source of external finance for the SMEs (Thorsten, 2007). It has been also observed that internal credit risk models have been used by the french banks to be able infer about the default possibilities, with the help of such models proper pricing of the SME loan portfolio can be prepared (Michel & Joel, 2002).

with the help of reform initiatives undertaken for uplifftinf of the finaancail sector policy maker can make sure that SME sector growth is stimulated. The research undertakes the framework of reforms and presents importnat tools which can be used to help the banking sector. Such reforms include SME Gross Cluster training programmes and modified secured transcation framework through there will be a change in the way banks examine SME as potential clients. With the introduction of improved lending technologies and

lending infrastructure, financial institutions can be promoted to help finance the growth of SMEs.

## **2. 6 Regulatory environment for SME sector and reforms**

Government of Pakistan embarked upon a programme of deregulating and liberalization of the economy in the 1990s. Reform aimed at reducing Government's interference in business was introduced in phases in the fiscal realm as well as in labour laws etc. The result of course, has been alleviation in regulatory burden to an extent. Businesses feel at a relative ease and are relieved to an extent from the constant and intrusive glare of numerous overseeing agencies. In this process, some of the factors causing hindrance in business through imposition of undue compliance requirements resulting in excessive paper work and interface with government agencies have abated. But it is too early to be conclusive about the fact that a problem for the industrial sector has been removed.

According to the SME Base-Line survey most of the SME viewed, Sales tax and labour laws to be elements of constraints for the growth of SMEs. Another important finding was constructed in Asian Development Bank report according to which tax rates are perceived as binding constraints by the SMEs (Bari, Cheema, & Haque, 2005). Along with these problems there is a element of regulatory hassled faced by the firms, figure two in the appendix section provides a useful insight into the burden faced by firms in different countries while dealing with governmental officials. The figure highlights the fact that Pakistan and India are closely matched when it comes to regulatory hassle. The least percentage is held by the Latin

American countries where the burden on the industries is minimal. It might  
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seem that the binding constraints are originated because of the tax rates, but the fact of the factor is that it is the administrative and corruption costs of regulation and taxation which creates a binding constraint on the SMEs to grow.

In recent times emphasis has been also upon the regulatory environment ratings along with the business environment rating to understand the elements which can help the progress of SMEs. There has been a special argument in favour of well defined property rights, and legal, judicial, and bankruptcy environment (Allen & Gregory, 2006). Literature has shown that more feasible a business environment is within an economy the greater the prospectus for the growth of SMEs. World Bank has introduced different governess indicators to reflect regulatory ratings with-in the economies. But these ratings have started to make its mark only in recent times and it will take time to fully incorporate these variables into the research process.

This raises the question to policy makers about the possible reforms which should be initiated to improve the regulatory environment in different economies. There has to be a well-defined property right framework which not only will provide support of SMEs directly but also help the banking sector to gauge understanding about the collateral provided, through which credit origination will gain pace. Further-more it's argued that Procedures to enforce a contract should be made more transparent and time taken to enforce contacts should be reduced (Ahmad, Nenova, & Niang, 2009). A reverberating regulatory environment will help to stimulate the growth of SMEs, because of improvement business environment as well.

## **2. 7 Poverty alleviation Strategies and Importance of SME Sector**

### **2. 8 Choice of Technology, labour absorption and employment generation**

A major reorganization is taking place around the globe in the service sector as well as the manufacturing sector. It has occupied the profile of rearrangement of industries, production process, and service activities to take over the practices of expenditure cutback while making sure that reliability is not compromised. These kinds of initiatives are mostly pioneered by SMEs, which encompass the volume of any economies' trade and industry units and contribute extensively to employment. In an ideal situation within the developing economy, who requires elements to grow and activities to generate employment SMEs are panicle predators waiting for the movement to strike. Because most SMEs are labour intensive, they invite a host of employment for different sectors of the economy. Labour absorption is extremely high when it comes to SME sector (Ismail, 2005). Considering the case of Pakistan, 90 % of all private sectors manufacturing entities offer work for less than 99 persons. SMEs' force is extremely energetic in the industrialized sector, even when most of this may be, employment creation at ' subsistence levels'. The encouragement has also been extended by International Labour Organisation (ILO); in their programme titles " Decent Work Country Programme" there has been a special emphasis placed on the role of SMEs. According to ILO in countries where there is extreme unemployment and women have lack of opportunities to enter into work places, SMEs play a vital role to balane the equation. They provide due employment for the residents of rural areas as well as create initiatives for

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the women of the society to join the labour force. The evolution of the developed nations has also depicted a similar story. During the transition phase, SME provided output and employment for the different sectors of the economy and paved the way towards structural transformation from lower-income economies to middle and high income economies (Bari, Cheema, & Haque, 2005).

But it's naive to consider that prefect conditions will persist in the economy and there will be no hurdle for SME sector. We have witnessed firm level factors as well as macroeconomic factor affection the way SMEs run their operations (Bari, Cheema, & Haque, 2005). This means that under the shadow of fabricated world, lies the brutal truth of ground realities because of binding constraints SMEs are not able to achieve their full potential of employing labour and of creating opportunities for the unemployed.

Furthermore the choices of technology available for the SMEs are few and far between. Although it has been suggested that Medium enterprises have much more technological choices, small firms lack the advanced technology required for operations. But the counter argument comes for few researchers according to whom Small industries are not required to have advanced technologies, because often they are referred to as cottage industries they have sufficient technology available with them (Gary, 2001). Another view point promoted is that SMEs lack competitive edge because of human skills, knowledge and strategic planning rather than the ability to have machines (Ismail, 2005). The greater the ability of the management to deal with fluctuations in the economic indicators, greater will be the growth progress of SMEs. Given that constraint variables are kept under check and SMEs are

allowed to achieve their full potential, than there are no valued assets than the SMEs to create opportunities and provide employment in the economy.