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## **BARRIERS TO GROWTH OF SMES IN LAHORE AND THEIR EFFECTS ON SMES**

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### **ABSTRACT**

The present study examines the barriers to growth in SMEs in Lahore. The barriers highlighted in this study include lack of capital, high production cost, overdue accounts receivables, high interest rates and difficulties in accessing credits. Primary data was collected through questionnaire asking questions on a five point Likert Scale. The data was, then, analyzed through SPSS using multiple regression and Pearson correlation. Results showed that barriers highlighted in this study have significant impact on the growth of SMEs in Lahore. Recommendations to minimize the effect of the mentioned factors were also provided in this study.

**Keywords:** SME; Lack of Capital, High Production Cost; Growth; Barriers; Lahore; Overdue Accounts Receivables, High Interest Rates.

### **INTRODUCTION**

Small and Medium enterprises play a pivotal role in the economic development of any country. The significant fact about SMEs is that it provides employment to low and middle income group in Pakistan. SMEs are the source for equitable distribution of capital and technology and play an active role in the development of the economies of the world.

Since the birth of Pakistan, large scale industry remained in the focus for the economic development. Small and Medium sized industries were either totally overlooked or these got very little attention from the administration of Pakistan. With the growing participation of SMEs in the economic development of the other countries in the world, an institution with the name of SMEDA was set up in Pakistan in October 1998 to monitor the overall performance of the SMEs in Pakistan and to cope with the constraints faced by them in producing the required results. According to SMEDA, "SMEs constitute nearly 90% of all

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the enterprises in Lahore; employ 80% of the non-agricultural labor force; and their share in the annual GDP is 40%” (SMEDA, 2009).

State Bank of Pakistan’s Prudential Regulations define SME as “an entity, ideally not a public limited company, which does not employ more than 250 persons (if it is manufacturing / service concern) and 50 persons (if it is trading concern) and also fulfills the following criteria of either ‘a’ and ‘c’ or ‘b’ and ‘c’ as relevant:

- a) A trading / service concern with total assets at cost excluding land and building up to Rs. 50 million.
- b) A manufacturing concern with total assets at cost excluding land and building up to Rs. 100 million.
- c) Any concern (trading, service or manufacturing) with net sales not exceeding Rs. 300 million as per latest financial statements” (Pakistan, Publications, 2009).

Pakistan is heavily relying on SMEs for the development of its economy. According to the Government Statistics, Pakistan’s SMEs sector recorded an impressive growth of 14.7% during 1987/88 – 1996/97 when the estimated value of its output increased from Rs. 19,683 million to Rs 67,541 million(Finance, 2005).

Meanwhile, the number of Small and Household Manufacturing Industries recorded growth of 5.8% in that period. The contribution of SMEs to Pakistan’s economy, employment and poverty reduction can be seen from the fact that 90% of all private sector manufacturing units employ less than 99 workers and the SMEs employ some 78% of non-agricultural labor force. They contribute about 30% to GDP, Rs. 140 billion to exports, and generate 25% of exported manufacture (Finance, 2005).

### **Barriers to Growth of SMEs in Lahore**

SME sector in Pakistan have been neglected since the birth of Pakistan. There have been so many problems that are hindering the growth of SMEs in Pakistan. Some of these problems are being introduced in this paper.

- Non-Availability of Concrete Data on the SME sector and Pakistan’s Economy: It creates problems for the institutions dealing with the SME sector, since financial

statements and accounts of many SMEs are non-existent. The lack of information is in itself a problem for the SMEs and it affects their success negatively.

- **Non-Conducive Regulatory and Legislative Frameworks:** Although, still Pakistan's small and medium entrepreneurs have to go through a lot to get their businesses registered, deal with the tax authorities, meet other documentation requirements and so on and so forth. This non-conducive regulatory and legislative framework cause problems for SME and affect them negatively.
- **Resistance to Change:** Due to back dated technology, minimal use of latest production and designing techniques and several other factors, entrepreneurs in Pakistan don't think about graduating from small to medium and then to large. Our economy needs an attractive business environment and an entrepreneurial culture for the change to take place. Educational institutions and private sector role players need to make sincere contributions, if the economy is to compete with the international market.
- **High Tax rates:** This is also a major obstacle in the way of SMEs. Government has imposed them high tax rates; because of these taxes, people of Pakistan are reluctant in setting up new ventures as major part of the profit is eaten up by the taxes imposed by the government.
- **Financing Gap:** This is one of the major obstacles for SMEs, they perceive that high risks and costs are associated with Bank's financing services; SMEs are short of sound collateral and abilities to present bankable business plans. Therefore, they find it very difficult to take loan from banks and fill up the financing gap in order to smooth their operations.
- **High Interest rates:** Because of capital needs if people want to take loan from a bank; they have to pay high interest rates to banks. That is why most SMEs do not apply for the loan because of their incapability to pay such high interest rates in the current recessionary conditions in the country.

- **Inadequate Business Support Service Providers:** SMEs are facing the mentioned problem because supports services in Pakistan are either too expensive or quality of services being provided to SMEs are not up to the mark. The SMEs need support services in the field of accounting, marketing, e-commerce, product designing, pricing, human resource development etc.
- **Human Resource, Raw Material and Technology:** Shortage of skilled labor causes delays in production and affects quality of output & sales. High price and unsatisfactory quality of raw material is a matter of great concern for those belonging to the manufacturing sector. The entrepreneurs are also interested in adopting new technologies and training manpower, but lack financial, technical and training resources. Lack of all these has led SMEs towards low productivity since the sector contributes only 30% towards value addition (Finance, 2005). One of the major reasons of these effects is illiteracy rate in Pakistan.
- **Political Environment** plays a very vital role in the growth and efficiency of the SME sector. If political environment is stable, people will confidently invest in various projects to earn because they will have in the back of their mind that no change in political set up is going to take place and economic conditions will prevail as they are. On the other hand, if the political environment is uncertain, people will hesitate in investing due to the fact that there will be uncertainty that Government might change in near future and new Government might change the economic policies of the country which might cause them loss. So, there will be less or no investment in these circumstances.

### **Research Problem**

In this research study, the researcher wanted to highlight the barriers that are hindering the growth of SMEs in Lahore and to what extent the effect of the mentioned variables are significant on the growth.

## **Objective**

The objective of the study is to find out the extent to which various barriers affect the growth of SMEs in Pakistan especially the effect of lack of capital, high production cost, high interest rates, overdue accounts receivables and difficulties in getting access to credit in Pakistan.

## **Significance of the Study**

SMEs are playing a significant role in the development of the countries around the world. These are sources to provide employment to the labor and play an active part in the exports of the countries. The present study is intended to highlight the importance of SMEs in Pakistan and to find out the adverse effects of various factors that are hindering the growth of SMEs in Pakistan and to suggest some remedies for betterment of the SME sector in Lahore.

## **Independent Variables**

For the purpose of this study, following are the independent variables:

- Lack of capital
- High production cost
- High interest rates
- Overdue accounts receivables
- Difficulties in getting access to credit

## **Dependent Variable**

Growth of SMEs in Lahore is the dependent variable for the sake of present study.

## **Hypotheses**

*H<sub>0</sub>:Lack of capital in the SME sector has no relationship with SME growth.*

*H<sub>1</sub>:Lack of capital in the SME sector has significant relationship with SME growth.*

*H<sub>0</sub>:Higher Production Costs in SME sector have no relationship with SME growth.*

*H<sub>1</sub>: Higher Production Costs in SME sector have significant relationship with SME growth.*

*H<sub>0</sub>: High Interest rates have no relationship with SME growth.*

*H<sub>1</sub>: High Interest rates have significant relationship with SME growth.*

*H<sub>0</sub>: SME Growth is not related to Overdue Accounts receivables.*

*H<sub>1</sub>: SME Growth is significantly related to Overdue Accounts Receivables.*

*H<sub>0</sub>: Difficulties in Accessing Credit in SME sector have significant relationship with SME growth.*

*H<sub>1</sub>: Difficulties in Accessing Credit in SME sector have significant relationship with SME growth.*

## **LITERATURE REVIEW**

Bari, Cheema, & Haq (2005) maintain in their research article titled “Barriers to SME growth in Pakistan: An analysis of constraints” that SMEs play a key role in providing employment to the work force of Pakistan. This working paper was published by Asian Development Bank. According to the researchers, SMEs in manufacturing are also playing fruitful part in exports of the country.

The researchers argued that SMEs are facing many problems in Pakistan including lack of access to credit, Excessive Government regulations, an arbitrary and exploitative tax system, a weak technological base and the lack of business support services (Bari, Cheema, & Haq, 2005, P. 05).

According to the researchers, despite the liberalization policies adopted by the Government for the last one and a half decades, which produced growth in other South Asian Economies, Pakistan is still on the slower side in terms of growth in the SME sector. Large Scale Industry has recovered significantly in the recent times but SMEs are yet to be recovered. The slowdown in growth of manufacturing, retail and wholesale sectors, in particular, is mainly due to the fact that their gross fixed capital formation have been halved.

This shows that the slowdown in growth and investment is mainly due to the policies of the government and the government needs to address this issue in order to gear up the growth in the SME sector (Bari, Cheema, & Haq, 2005, P. 11).

The researchers provided a broad strategy for growth and investment revival by placing special emphasis on removing the constraints of SMEs' growth and investment. According to the researcher, SMEs work their significant contribution in Pakistan's value added (30%) and employment (80%). Secondly, the growth of labor intensive SMEs is needed to be maximized because there are great prospects for their growth in accordance with the open and liberalized policy of the Government (Finance, 2005).

The researchers maintained that SMEs are not growing according to the potential they have. The study showed that growth rate of the SME sectors has been halved from the growth rate of 80s and 90s despite the fact that government had adopted the open and liberalization policy in the 90s. The researchers argued that more important fact is the lack of structural changes which is measured by the inertia in the value added structure of SMEs in Pakistan.

The researchers conducted a survey from August 2002 to January 2003. They used qualitative research methodology for their research. They selected a sample of 60 firms and asked them about the major constraints in their point of view. The researchers asked the entrepreneurs to rank each constraint from 1 (Least important) to 5 (Severe). The researchers used the surveyed data to rank all the constraints and called all those constraint as Binding constraints which obtained a score of 3.5 and above and which 30% of the respondents ranked as above average constraint (Bari, Cheema, & Haq, 2005, P. 05).

The researchers had taken the sample from the manufacturing and retail stores because of their significant contribution in the slow growth rate of SMEs in the last decade. Within Manufacturing, they chose food, beverages, garments, made ups and light engineering units to conduct the survey. The sample chosen was a mix of SMEs and large firms because the objective was to know about size specific constraints.

From the data of the surveys, the researchers arrived at the following conclusion:

- i. The researchers found out that the main constraint for SMEs is Credit Rationing in formal sector credit market. However, this constraint is not binding on the large scale industries.
- ii. The researchers found that the high cost of finance and leasing cost is another binding constraint owing to the fact that State Bank of Pakistan offered high interest bearing risk free securities in 2002 to the people. Non-performing loan portfolio is the other reason for the high cost of funds.
- iii. The researchers found that high compliance cost is another binding constraint as rules and regulations involve direct contact between officials and the firms, the laws are complicated and nontransparent which lead to corruption that increases the cost of compliance.
- iv. The researchers concluded that poor infrastructure, particularly in the power sector; increase the cost of growth for the firms irrespective of their size.
- v. Lack of skills, training and education among workers is another binding reason due to the fact that education level and training level is below average in Pakistan (Bari, Cheema, & Haq, 2005, P. 38).

The researchers, in the recommendations section, maintained that collateral requirement must be revisited; Rules and regulations must be enforced properly, procedures and processes must be simplified; financial costs must be reduced (Bari, Cheema, & Haq, 2005, P. 40).

Quader & Abdullah (2009) argued in their article titled “Constraints to SMEs: A Rotated Factor Analysis Approach” that SMEs eliminate unemployment, avoid additional costs, minimize the investment risks, ensure an equitable distributions of income and products, check imbalances between different pockets of economy and maximize the use of locally available raw materials.

The researchers argued that main advantages of SMEs in developing countries are high labor intensity, dependence on indigenous skills and technology, contributions to entrepreneurship, development, innovativeness and growth of industrial linkages (Ahmed, 2001).



In Bangladesh, small and medium enterprises have been facing multifarious problems related to raw materials, power, land, marketing, transport, technical facilities and finance (Ranjit & Rashid, 1996). According to the researcher, the objective for writing this article is to find the extent, to which financial constraints, regulatory constraints; physical, technical and marketing inputs that affect the SMEs' operations (Quader & Abdullah, 2009, P. 05).

The researchers designed research methodology in two phases. In the first phase, the researchers conducted interviews of the businessman, bankers, government officials and donor organization officials. In the second phase, the researchers developed a questionnaire to be filled in by the SME owners in Bangladesh. The questions asked from the respondents were about the key constraints faced by the SMEs including lack of access to credit, excessive government regulation, arbitrary and exploitive tax administration system, a weak technological base and lack of business support system (Quader & Abdullah, 2009, P. 06).

The researchers have identified 18 variables under three categories and asked the respondents to evaluate each constraint using score on five points Likert Scale. The researchers have taken a sample of 60 firms in order to find out their views about the constraints. The researchers used quota sampling to choose the sample because the researchers wanted to include various sub groups in the population in order to make the sample representative for the research study (Quader & Abdullah, 2009, P. 07).

The researchers analyzed data in two phases. In the first phase, the researchers used the survey data in order to find the "Binding Constraints". According to the researchers, all those constraints that have been marked 305 or above or those variables which are ranked above average by 30% or more respondents are binding constraints for the purpose of this study.

In the second phase, the researchers analyzed the factors by using varimax/promax normalizes method. According to the researchers, this method is simple and relatively fast to arrive at the results.

In the data analysis phase, the researchers found out that there are seven constraints out of eighteen which are binding constraints. According to the researcher, the binding constraints include unavailability of funds, interest on bank loan, high cost of raw materials,

high cost of equipment, lack of protective measurement, unavailability of skilled worker and scarcity of technical skill (Quader & Abdullah, 2009, P. 08).

Following are the conclusions of the researchers, based upon data analysis:

- There was no SME policy in Bangladesh.
- Small firms were discriminated against the large firms.
- High lending rate is the main constraint for SME growth in Bangladesh.
- Although there was no deliberate legal or administrative discrimination, yet SMEs are susceptible to unequal treatment due to dissimilarity in economic capacities, transition phases, resource potential, location reasons, and lack of well-disposed connections.
- Collateral need and small domestic market size, lack of technically skilled workers, lack of physical input (Raw materials), unavailability of financing and high equipment cost, lack of protective measures and uncertainty also show lack of government support in SMEs to compete in global arena (Quader & Abdullah, 2009, P. 14).

### **DATA COLLECTION AND ANALYSIS**

For the purpose of this study, primary data was collected in order to arrive at a conclusion. Data was collected through questionnaire from SMEs in different parts of Lahore. 30 entrepreneurs were visited and the researcher got the questionnaire filled by them from Abid Market, Egerton Road, Shah Alam Market and Azam Cloth Market. Selection of different areas of Lahore was done through convenience sampling due to the fact that most of the SMEs in Lahore are in these areas and the researcher wants to make the sample size representative of the population. The questions were asked from the respondents using five point likert scale and the responses were recorded and analyzed using SPSS.

Descriptive statistics was used to analyze data. The tested the relationship between independent and dependent variable by using multiple regression analysis to show the

relation among SME growth and lack of capital, High Production cost, high interest rates, Difficulties in accessing credits and Overdue accounts Receivables. The researcher also used Pearson correlation Co-efficient (2-Tailed Test) to check the correlation among the variables. The results of the research study are hereunder:

TABLE 1

## Lack of Capital

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	very high effect	15	50	50	50
	high effect	6	20	20	70
	I don't know	0	0	0	70
	low effect	5	16.67	16.67	86.67
	very low effect	4	13.33	13.33	100.0
	Total	30	100.0	100.0	

From the table given above, it is evident that 50% of the respondents are ranking very high effect of lack of capital on SME growth. 20% of the respondents say high effect, 16.67% say low effect and 13.33% say very low effect. On aggregate 70% of the respondents agree that lack of capital has a significant effect on growth of the SME and 30% disagree to this statement.

TABLE 2

## High Production Cost

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	very high effect	11	36.67	36.67	36.67
	high effect	14	46.67	46.67	83.34
	I don't know	1	3.33	3.33	86.67

	Frequency	Percent	Valid Percent	Cumulative Percent
low effect	1	3.33	3.33	90
very low effect	3	10	10	100.0
Total	30	100.0	100.0	

According to the results shown in the above mentioned table and pie chart, 36.67% of the respondents think that high production cost has high effect on the growth of the business, 46.67% think that there is a high effect on the growth of the business, 3.33% do not know about this problem. 3.33% think that the effect of high production cost on business growth is low and 10% think that the effect is very low. Overall 83.67% of the respondents have the opinion that high production cost does affect the growth of the business.

TABLE 3

## Overdue Account receivables

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid very high effect	9	30	30	30
high effect	9	30	30	60
I don't know	0	0	0	60
low effect	8	26.67	26.67	86.67
very low effect	4	13.33	13.33	100.0
Total	30	100.0	100.0	

The above pie chart and the table depict that 30% of the respondents think that overdue account receivables have a very high effect on the growth of the business. 30% think the effect is high, 26.67% say that there is a low effect on the efficiency of the business and 13.33% think that the effect of overdue account receivable is very low on the growth of the SMEs. On aggregate 60% of the respondents think that the effect of overdue account

receivable is high and 30% of the respondents think that the effect of the variable is low on the growth of the business.

TABLE 4

## Difficulties in accessing credit

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid very high effect	14	46.67	46.67	46.67
high effect	4	13.33	13.33	60
I don't know	1	3.33	3.33	63.33
low effect	6	20	20	83.33
very low effect	5	16.67	16.67	100.0
Total	30	100.0	100.0	

The results show that 46.67% respondents think that the effect of difficulties in having access to the credit has a very high effect on the growth of the business. 13.3% says that it has a high effect, 3.33% remain neutral. 20% say low effect and 16.67% think that the mentioned problem has a very low effect on the growth of the business.

TABLE 05

## High Interest Rate

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid very high effect	13	43.33	43.33	43.33
high effect	11	36.67	36.67	80
I dont know	0	0	0	80
low effect	3	10	10	90
very low effect	3	10	10	100.0

	Frequency	Percent	Valid Percent	Cumulative Percent
Total	30	100.0	100.0	

This data shows that 43.33% of the respondents declare a very high effect of the problem mentioned above on the growth of the business, 36.67% say that the effect is high, 10% say that the effect is low and 10% of the respondents think that there is a very low effect of high interest rate on the efficiency of the business.

TABLE 6

		Monthly Income	Lack of Cap	HPC	OAR	DIAC	HIR
Monthly Income	Pearson Correlation	1	-.018	-.058	-.069	-.090	-.228(*)
	Sig. (2-tailed)	.	.860	.577	.506	.390	.027
	N	30	30	30	30	30	30
Lack Cap	Pearson Correlation	-.018	1	.450(**)	.305(**)	.442(*)	.260(*)
	Sig. (2-tailed)	.860	.	.000	.003	.000	.011
HPC	Pearson Correlation	-.058	.450(**)	1	.375(**)	.315(*)	.297(*)
	Sig. (2-tailed)	.577	.000	.	.000	.002	.004
OAR	Pearson Correlation	-.069	.305(**)	.375(**)	1	.264(*)	.097
	Sig. (2-tailed)	.506	.003	.000	.	.010	.353
DIAC	Pearson Correlation	-.090	.442(**)	.315(**)	.264(*)	1	.590(*)
	Sig. (2-tailed)	.390	.000	.002	.010	.	.000
HIR	Pearson Correlation	-.228(*)	.260(*)	.297(**)	.097	.590(*)	1
	Sig. (2-tailed)	.027	.011	.004	.353	.000	.
	N	30	30	30	30	30	30

For the sake of testing hypothesis, the researcher applied multiple regression and correlation analysis to establish whether the hypotheses are accepted or rejected. The results of regression analysis show that chosen variables are very significant and their effect is very strong on the growth of the business in SME sector. The table shows that all the variables

whose beta is less than 0.05 (5% significant level) are significant and place a strong impact on the growth of the variables under discussion. It is also worth mentioning that the researcher has quantified growth in terms of monthly income. The researcher has divided the monthly income into two groups, i.e. income less than or equal to Rs. 100,000 and income greater than Rs. 100,000. The researcher has also applied Pearson correlation coefficient for two tailed test and the results show that the relationship among the variables under discussion is very strong and change in one variable will significantly affect the value of the other variable.

### **CONCLUSION**

Based upon the above mentioned facts and figures, the researcher is able to conclude that the mentioned factors do affect the growth of SMEs in Lahore and the impact of these factors is significant. The results also show that barriers highlighted in the research are positively correlated with each other and negatively correlated with the growth of SMEs in Lahore. The results also showed that all the variables whose beta is less than 0.05 (5% significant level) are significant and place a strong impact on the growth of SMEs in Lahore.

As far as hypotheses are concerned, it is concluded that all null hypotheses are rejected and all alternative hypotheses are accepted. This implies that the variables under discussion significantly affect the growth of the SME sector in Lahore.

### **Recommendations**

Based upon the research results, Recommendations are as follows:

- Government must take immediate steps to provide capital to SMEs through loan with suitable terms and conditions so that SMEs may find opportunity to grow in the current economic conditions in Pakistan.
- There is no legal framework for overdue accounts receivables in Pakistan for SMEs. There should be a legal system through which an effective legal action may be taken against the delayed payers in order to improve the operational circle of the SMEs.

- Interest rates are too high in Pakistan. Government should provide loans to SMEs on subsidized rates so that these may be able to improve their deficiency of capital and may find opportunities to expand their business.
- SMEs should try to reduce their production cost by reducing the amount of waste, by hiring trained staff and by improving internal controls. The government should take steps to provide raw materials to SMEs on subsidized rates in order to provide them an opportunity to grow.

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