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Corporate Governance in Small & Medium Enterprises

by

Naghmana

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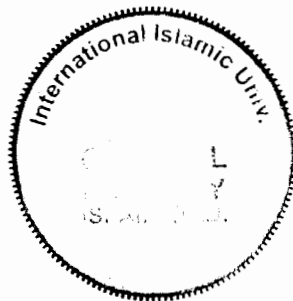
Supervisor: Mr. Muhammad Zubair Abbasi



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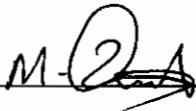
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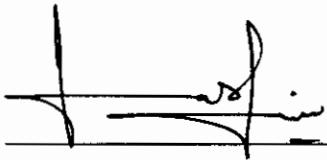
Mr. Muhammad Zubair Abbasi

SUPERVISOR



Mr. Uzair Hashim

EXTERNAL EXAMINER



Mr. Muhammad Younus
Lecturer (FSL)

INTERNAL EXAMINER



Naghmana

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List of Abbreviations

ARD	Alternative Dispute Resolution
BOD	Board of Directors
CSR	Corporate Social Responsibility
CSO	Corporate Social Opportunity
CG	Corporate Governance
CLS	Core Labor Standards
CEACR	Committee of Experts on the Application of conventions and Recommendations
CLRSG	Corporate Law Review Steering Group
EU	European Union
EPRCP	Environmental Planning and Resource Conservation Project
ESSO	Employees Social Security Ordinance
FRSSE	Financial Reporting Standards for Smaller Entities
FBS	Federal Bureau of Statistics
FDI	Foreign Direct Investment
FIFA	Federation of International Football Association
GSC	Global Supply Chain
HRM	Human Right Management
HR	Human Resource
HRD	Human Resource Development
ICT	Information and Communication Technology
ICGN	International Corporate Governance Network

ISO	International Standards Organization
ILO	International Labour Organization
IT	Information Technology
ITUC	International Trade Union Confederation
IRO	Industrial Relation Ordinance
IPR	Intellectual Property Rights
LGC	Lahore Garments Consortium
LSI	Large Scale Industries
LDC	Low Developing Countries
MOIP&SI	Ministry of Industries, Production and Special Initiatives
NCS	National Conservation Strategy
NWFP	North West Frontier Province
NBFC	Non-Banking Finance Corporation
NCSMEs	National Committee on Small and Medium Enterprises
NIRC	National Industrial Relations Commission
OECD	Organization of Economic Cooperation and Development
OMB	Office of Management and Budget
PCSMEs	Provincial Committees on Small and Medium Enterprises
PEPO	Pakistan Environmental Protection Ordinance
PRA	Paperwork Reduction Act
QCD	Quality Cost Delivery
R&D	Research and Development
SME	Small & Medium Enterprises
SMEDA	Small and Medium Enterprises Development Authority

SECP	Securities Exchange Commission of Pakistan
SBP	State Bank of Pakistan
SPS	Sanitary and Phytosanitary
SBREFA	Small Business Regulatory Enforcement Fairness Act
SBPRA	Small Business Paperwork Relief Act
TNC	Transnational Corporation
TC	Technological Capability
TBT	Technical Barriers to Trade
UNIDO	United Nations Industrial Development Organization
UNCTAD	United Nations Conference on Trade and Development
WCM	World Class Manufacturing
WTO	World Trade Organization

Dedication

Dedicated to my father, to whom I owe everything.

Acknowledgment

The purpose of this thesis besides the fulfillment of partial requirements of degree of LL.M (Corporate Law) is also an endeavor to highlight the problems of SMEs in Pakistan in the perspective of corporate governance.

I hope this effort will be helpful and beneficial for the students, policy makers and regulators for further improving this concept.

I would like to acknowledge my gratitude to my supervisor Mr. Muhammad Zubair Abbasi, for his sincere suggestions, qualified approach and dedication to the supervision of my research work. He has not only indebted me but has truly helped me achieve this research work in the present form.

I would like to acknowledge the care and support of my family that has enabled me to undertake my studies with diligence and determination.

Abstract

The concept of “effective legal framework for SMEs” got importance due to the internationalization of world markets for products. In this context, SMEs in Pakistan face various financial, human resource, infrastructural (technological) and regulatory problems which hinder their competitiveness in international markets. Such problems can be resolved through reforms in the existing legal framework for the SMEs. The compliance of regulatory, environmental, labour, and intellectual property laws by the SMEs will help in addressing their problems at grass root level without attracting international sanctions for their products despite their being regulatory cost associated with such compliance. This research work highlights the contemporary problems faced by the SMEs in Pakistan at national and international levels in order to provide a remedy. It is found that most of these problems can be solved by reforming the existing legal framework for the SMEs by simplification of regulatory laws. Additionally, tax concessions should be granted for new industries and access to finance (in the form of micro finance schemes and promotion of Foreign Direct Investment) be provided to the SMEs.

Introduction

Thesis statement

Effective legal framework for SMEs in Pakistan in the globalized world

Globalization and Internationalization of markets are influencing all the businesses in the contemporary world. Strong industrial set up plays a decisive role in the economic strength of a country. World trend is moving from Geo-politics to Geo-economics. The developed countries are utilizing the maximum benefits of scientific and technological advancement. In these countries, large scale industries are at a very advanced stage. In contrast to this, Small and Medium Enterprises (SMEs)¹ are the major producers of goods in the developing countries. Such SMEs are frequently encountered by problems like scarcity of capital, scientific know how and are, in addition, blamed for child and bonded labour practices.

In order to maintain their industrial monopoly the developed countries are introducing new laws and regulations for the developing countries on international level, which are to be followed before exporting their products to the foreign markets. A recent example in this regard is the announcement by the Federation of International Football Association not to buy soccer balls made with the help of child labour in Pakistan.²

The economy of developing countries is SMEs oriented. They are efficient utilizers of scarce capital and abundant labour force. The only factor undermining their role is the

¹ Small and Medium Enterprises play an important role in the economic uplift of the developing countries. These industries are efficient utilizers of the locally available raw material and employ the abundant manual labor. They operate on small scale with minimum capital and do not need access to modern technology for their operation.

² Farkhanda Mansoor, (2004), The WTO versus the ILO and the case of child labour, Web Journal of Current Legal Issues, Available at <http://webjcli.ncl.ac.uk/2004/issuc2/mansoor2.html> (Accessed October 23, 2008), p 2.

lack of compliance of legal framework by the SMEs. This is acting as a constraint on enhancing their performance and export capabilities. The approach of these countries is based on the fact that compliance with the laws aimed at effective Corporate Governance³ will increase the financial burdens of these enterprises. However if viewed from a broader aspect, the compliance of Corporate Governance laws will solve the problems of SMEs, like access to capital via Banks, right of selling products beyond the national frontiers and a chance to get benefit from Information and Communication Technologies (ICT). Due to the practice of not following a legal framework the rights of stakeholders in SMEs are vulnerable, giving rise to the lack of transparency in transactions and in long run breeds corruption. Hence there is a need to examine the status of contemporary Corporate Governance laws in Pakistan in perspective of a legal framework for its SMEs sector.

The issues of SMEs in Pakistan have been discussed in the books related to issues in Pakistan economy or in various Research papers and Articles. S. Akbar Zaidi in his book "*Issues in Pakistan Economy*" has analyzed the issues faced by the SMEs in Pakistan from historical perspective that how the government policies favored the LSI while neglecting the SMEs. According to him the availability of credit seems to be the most binding constraint on the growth of SMEs in Pakistan.⁴ Faisal Bari et. al, in their working paper series of "*SME development in Pakistan*" have analyzed the potential SMEs as engine for economic development of Pakistan, along with highlighting the binding constraints on their growth and giving recommendations.⁵ The article of Harron H. Hamid and Valeria Kozich,

³ Corporate Governance generally means the way in which companies are governed. It includes the companies' laws and all other enacted rules and regulations which the company has to follow in conduction of its business. Along with specifying the rights of a company towards its stakeholders and to the society at large.

Shaikh Khalid Hussain, (2004), The control of corporation: An analytical study of mechanism employed in non-financial listed firms of Pakistan, PhD Dissertation, University of Karachi; Pakistan, pp 18-19.

⁴ S. Akbar Zaidi, (1999), Issues in Pakistan Economy, Oxford University Press, pp 126-131.

⁵ Faisal Bari, Ali Cheema, Ehsan-ul-Haq, (2005), SME Development in Pakistan, Analyzing the constraints to growth, Pakistan Resident Mission Working paper Series No.3, Asian Development Bank, pp 17-57.

“Corporate Governance in an emerging market: A perspective on Pakistan” quite briefly takes a critical overview of the existing Corporate Governance Laws in Pakistan. However their work addresses the problem of compliance of Corporate Governance rules in perspective of the LSI.⁶ A lot of research work is done on analyzing SMEs problems and giving recommendations for their solution. However there seems to be no systematic work on linking the concepts of SMEs and Corporate Governance in Pakistan in the situation of mounting pressure upon the SMEs to comply with the Corporate Social Responsibility (CSR)⁷ movement and Core Labor Standards (CLS)⁸. Hence there is a need to take an in-depth analysis of this very important contemporary economic legal issue relating to a very significant aspect of economic development of Pakistan.

These legal issues of SMEs require careful examination of the existing Corporate Governance laws of Pakistan. As to how they can be modified and simplified so as to promote the interest of the SMEs. Because the prevailing system of Corporate Governance Laws in Pakistan does not discriminate between the LSI and SMEs regarding their compliance, there is a need to promote the concept of *“Think Small First”*,⁹ being successfully applied by the UK for granting maximum regulatory concessions to their SMEs on account of their size. The enactment of Code of Corporate Governance 2002 by the Securities and Exchange Commission of Pakistan (SECP) and the establishment of Small and Medium Enterprise Development Authority (SMEDA) are good efforts for promoting Corporate

⁶ Haroon. H. Hamid and Valeria Kozhich, (2006), *Corporate governance in an emerging market: A perspective on Pakistan*. Journal of Legal Technology Risk Management, Vol.1.No 1, pp 22-31.

⁷ Corporate Social Responsibility is a movement started by the developed countries according to which a company has to ensure the safety of its workers, protect the rights of its stakeholders and operate its business with full compliance of all the national and international environmental laws.

⁸ Core Labor Standards are the basic standards related to employed labor of companies, set by the ILO and which are to be followed its members. It aims at elimination of child labor and bonded labor practices, the trends common in the industrial sector of the developing countries.

⁹ The UK company law had being reformed so as to give maximum relaxation to their SMEs regarding regulatory and administrative procedures. UK Company Law, (2006), pp 233-235.

Governance culture in the SMEs sector. Similarly the SME policy 2007 of Pakistan tried its best to offer maximum institutional support to this sector. The need of the hour is to raise awareness among the SMEs owners that the following of Corporate Governance framework will enhance their performance.

The prevailing misconception that compliance of Corporate Governance rules will increase the financial burdens of SMEs needs to be addressed. They should be let to realize that how these laws can solve their problems, increase their efficiency and the chances for internationalizing of their products. SMEs in Pakistan are in their transitional stages. Government needs to grant them some incentives and concessions for their compliances with the Code of Corporate Governance on the patterns of other successful countries like the reforms of UK Company Law for their small businesses. This thesis will address the relevancy of Corporate Governance to the SMEs in contemporary world along with discussing the issues faced by the SMEs of Pakistan in the wake of globalization, while giving recommendations for encouraging the corporatization of SMEs and their operation within effective legal framework. Finally, this thesis draws the attention of the government towards the implementation strategies of Corporate Governance laws on SMEs.

For analyzing the issue of effective legal framework for SMEs in Pakistan, the thesis has been divided into three main chapters: Chapter one discusses the concept of Corporate Governance briefly. It states that how the Corporate Governance becomes relevant to the SMEs in the wake of globalization and internationalization. Chapter two examines and analyzes the contemporary problems faced by the SMEs in Pakistan. It elaborates that how the non-compliance of regulatory laws are having an adverse impact on the overall performance of SMEs specifically on its export performance.

Chapter three gives a legal framework within which the contemporary problems of SMEs can be addressed. It focuses on the simplification of the existing SMEs laws. It discusses that how the corporatization of SMEs can be encouraged by granting them relaxation in fiscal matters. It also gives suggestions that how the government can play an effective role in promoting entrepreneur culture through initiating micro financing schemes and by linking SMEs with the Transnational Corporations (TNCs).

Chapter 1

SMEs in the contemporary world

A strong and vibrant SME sector plays an important role in the economic development of the countries. This role becomes much important when viewed from the perspective of the developing countries. The SMEs of the contemporary world have to accept the challenges of globalization to remain competitive. The modern competitive economy promulgates new rules and regulations and the company adaptive to such changes can trade in the world market.

In this globalized world the quality and originality of product is not only the parameter for judging the competitiveness of a company but it's the compliance of a company with all of the International Human Resource Standards, Legal Standards and Environmental Standards that imparts the status of competitiveness to a company. In this situation the compliance of SMEs with National and International legal frameworks becomes inevitable. Corporate Governance is a holistic term and its application to the LSI and SMEs is of equal importance. Corporate Governance provides a strong institutional setup to the SMEs. It imparts transparency to the financial records of the company and confers a legal status upon them.

Though Corporate Governance rules were initially meant for LSI, but it is in the wake of its importance for the SMEs that UK has introduced reforms for its SMEs by granting them relaxation in regulatory and procedural matters. In Pakistan the SMEs mostly do not comply with Corporate Governance laws, as to them it will make business a costly affair. The need of the hour is to realize the importance of Corporate Governance laws for SMEs at state level. As it is due to the compliance of SMEs with Corporate Governance laws that SMEs can face the challenges of globalization and internationalization.

This chapter evaluates the status of SMEs in the contemporary world. It gives a brief review of the current approaches towards Corporate Governance along with analyzing the impact of Corporate Governance upon the SMEs.

1.1 Introduction

SMEs are regarded as the major contributors to the world economy. They received attention in the academic and political fields during the last decade.¹⁰ SMEs are the units of modern manufacturing and services in the globalized world. It's due to their immense importance that governments around the world are reforming their strategies to offer maximum facilities to the SMEs for enhancing their performance. This trend is common even in the developed countries where the Large Industrial Units are doing well.¹¹ For gaining competitive advantages globally, the SMEs have to redesign their strategies in accordance with the process of global focussing. As in contemporary world competitive advantages are gained by the companies capable of exporting their services and products to the international markets. International exposure gives the SMEs an opportunity to operate in a diversified market and to comply with international regulations.¹² However to achieve this purpose the SMEs have to ensure a strong institutional setup and an effective management strategy for their survival and success in the contemporary world.¹³

¹⁰ Zulfiqar Khan and Rajeev. K. Bali, (2007), Developing a (Business Process Improvement) BPI framework and (Performance assessment methodology) PAM for SMEs, Vol. 107, No 3, Available at <http://www.emeraldinsight.com> (Accessed April 2, 2009), p 345.

¹¹ Sanjaya Lall, (2000), Strengthening SMEs for International competitiveness, Available at <http://www.worldbank.org/mdf/mdf3/papers/firm/lall.pdf> (Accessed April 5, 2009), p 2.

¹² Klaus E. Meyer, (2009), Corporate strategies under pressures of Globalization: Global focusing, Available at <http://www.klausmeyer.co.uk/publications> (Accessed April 5, 2009), pp 1-4.

¹³ John Loan –Clarke et al, (2002), Competence Based Management Development In Small and Medium Sizes Enterprises: A multi stakeholder analysis, International journal of training and development, vol. 4. No. 3, Available at <http://www3.interscience.wiley.com/journal> (Accessed April 8, 2009), pp 176-195.

The revival of increased interest in SMEs is due to the recognition of their potential to innovate, grow, compete and export their products according to the new trends efficiently.¹⁴ The share of SMEs in the economy of OECD countries ranges between 96% and 99%. In Europe 90% of the companies are SMEs. According to European Commission SMEs play a significant role in providing employment, promoting export and are an important factor of social and economic stability of an economy. In US, SMEs account for about 40 % of its total GDP. SMEs are the major engine of jobs creation in China.

Though SMEs play a decisive role in the economies of many countries around the world, they still are encountered by various problems when compared with Large Scale Industries.¹⁵ The major threat to the survival of SMEs is globalization, according to which the traditional modes of competition are replaced by upgrading quality, design and reliability of the products on modern technological lines. This technological based development is to be followed by both the developed and developing countries. Apart from globalization the SMEs in general face three basic problems: small size, market fluctuations and lack of a coherent and integrated applicable policy.¹⁶ It is difficult to define SMEs in terms which are acceptable globally. However various departments of business, commerce and economics literature defines SMEs according to their respective concepts.¹⁷ Some countries classify SMEs according to the specific purpose for which they carry business, while to others qualitative and quantitative definitions are more relevant.¹⁸

¹⁴ Sanjaya Lall, (2000), Strengthening SMEs for International competitiveness, p 4.

¹⁵ Lutz Sommer, (2008), Cooperation Among SME - The Role of Owner Manger's Attitudes, Sigmaringen University, Germany Manual Huage, Available at [http ;//cluteinstitute.onlinejournals.com/Puerto rico.2008.pdf](http://cluteinstitute.onlinejournals.com/Puerto rico.2008.pdf) (Accessed April 5, 2009), p 1.

¹⁶ Sanjaya Lall,(2000), Strengthening SMEs for International competitiveness, pp 6-9.

¹⁷ Stephen M. Mutalla, Pieter van Brakel, (2006), E -readiness of SMEs in the ICT, Electronic Journal, Vol 24, No 3, Available at <http ;//www.emeraldinsight.com/insight.com/view.pdf> (Accessed April 8, 2009), pp 402-417.

¹⁸ Malcolm Harper, (1985), Small Business in the third World, Cranfield, John Wiley and sons, p 58.

The OECD defines SMEs: "The non- Subsidiary independent firms that employ fewer then a given number of employees."¹⁹ Other definition of SMEs is that the SMEs are the ones employing less then 500 employees.²⁰ In most of the EU countries, the definition of SMEs is based on legal and statistical terms. The legal definition considers the number of employees, annual balance sheet and independence of a firm. In countries like US and Germany where statistical definitions are relevant takes into account the number of employees and the total income of the enterprise. In UK definition of SMEs is based on the number of employees.²¹

The SMEs are having simple institutional setup, with a few employees along with a narrow diversified production capacity. The distinguishing feature of SMEs is their being labour intensive²² and its ownership is usually in the hands of one or a few persons, who are responsible for the overall functioning of the enterprise.²³ SMEs play an important role in developing countries in promoting the exports.²⁴ SMEs accounts for 25-35% of the world's manufactured exports. To improve this export ratio SMEs have to become more competitive as globalization has set new parameters for exporting goods both at domestic and international market level according to which the export performance of a company is determined both by controllable and uncontrollable factors. The controllable factors include the domestic factors like firm size, management, competitiveness and quality of production.

¹⁹ Debra Jhonson and Collin Turner, (2003), *International Business, Themes and issues in the modern global economy*, London Routledge, p 126.

²⁰ Stephen M. Mutalla, Pieter van Brakel, (2006), *E-readiness of SMEs in the ICT*, pp 402-417.

²¹ Andrea Lindner, (2005), *Organisation for economic cooperation and development, Expert group meeting on Industrial statistics*, New York, Available at <http://unstats.un.org/unsd/industry/meetings/eg2005/pdf>. (Accessed April 15, 2009), p 8.

²² Pual Higgs, Patrick Le Roy, Laim Tierney, (1996), *Manufacturing Planning and Control Beyond MRP2*, Available at <http://books.google.com.pk> (Accessed August 4, 2009), pp 225-226.

²³ Abhor and Charles K.D. Adjasi, (2007), *Corporate governance and small and medium enterprises sector: Theory and implications*, Available at <http://www.emeraldinsight.com/insight/content/service> (Accessed April 24, 2009), pp 111-122.

²⁴ Kent E. Neupert, C.Christopher Beughn, Thi Thanh Lam Dao, (2006), *SME exporting challenges in transitional and developed economies*, *Journal of small business and enterprise development*, Vol 13, No 4, Available at <http://www.emeraldinsight.com/pdf> (Accessed April 5, 2009) , pp 535-545.

While the uncontrollable factors are the international rules and regulations to followed by the companies' before exporting their products.²⁵

SMEs and their financing are the latest trends in Pakistani economy. Studies regarding SMEs got momentum after the emergence of Small Medium Enterprises Authority (SMEDA) and SME Bank. In contemporary world, Pakistan is a developing country and is recently shifted from the list of low income countries to middle income countries. SMEs in Pakistan are contributing up to 30% of national GDP, 25% in export earning and employing about 78% of non-agricultural labour force.²⁶ According to the statistics of Federal Bureau of Statistics (FBS) of 2007, there are 3.2 million establishments in Pakistan which come under the category of SMEs. These statistics indicates that how the effective management of SMEs can improve their performance and can play a role in economic uplift of the country.²⁷

1.1.1 Impact of Globalization and Internationalization upon SMEs

The trend of globalization has its impact on every business of the world. Technological progress enables every business to buy, sell and cooperate on global scale. As a result of this trend, the SMEs have to see themselves in the global context before embarking upon launching any project in the world market. However the decision to the globalized world needs, strong commitment and determination on part of the SMEs is required to overcome

²⁵ Muhammad Suhail Nazar, Hassan Mujtaba Nawaz Saleem, (2009), Firm-Level Determinants Of Export Performance, International Business & Economics Research Journal-February, Vol 8, No 2, Available at <http://www.cluteinstitute-onlinejournals.com/PDFs/1695.pdf> (Accessed August 5, 2009), p 105.

²⁶ Shahid Saleem, (2008), SMEDA SME Policy paper 2007, A Critical Review (An analytical commentary upon SME policy proposed by SMEDA Pakistan), Available at <http://www.mpra.ub.uni.muenchen.de/pdf> (Accessed April 5, 2009), p 2.

²⁷ Shahnawaz Mehmood, (2008), Corporate Governance and Business Ethics for SMEs in developing Countries: Challenges and the way Forward, Available at <http://www.isbce.org/index.php?option=com.docman&task=doc-download&gid=181&Itemid=9> (Accessed April 23, 2009), pp 1-2.

the numerous difficulties, which accompany internationalization of business.²⁸ In this process of globalization the SMEs can act as engines of growth “for product market innovations and broader economic development of nations.”²⁹

Globalization has a profound effect upon the SMEs. The basic motivating factors behind the globalization of businesses are the growth of low cost technology connecting people, diminishing trade barriers, widespread economic restructuring and liberalization.³⁰ Due to the accelerating rate of globalization and internationalization even in the developed countries companies are facing competitive challenges in the world market.³¹ In the globalized world to get contracts SMEs need to prove their competitiveness by complying with Quality, Cost and Delivery (QCD) criteria. These companies are in need of attaining World Class Manufacturing (WCM)³² status in order to reach the world class standards.³³ The SMEs for their survival in global competitive environment have to fully utilize the benefits of Information Communication Technology (ICT), through which they can get access to global markets and compete with large corporations. The European Commission in June 2000 introduced a programme for its SMEs to go digital through a coordinated networking activity for exchange of information on best practices and by incorporating e-commerce into their business strategies.³⁴

²⁸ Globalization is the growing interdependence of national economies-involving consumers, producers, suppliers and governments.

Dagmar Recklies, (2001), Small and medium-sized enterprises and globalization, Available at <http://www.themanager.org/strategy/global.htm> (Accessed April 6, 2009), p 1.

²⁹ Gary Knight, (2000), Entrepreneurship and marketing strategy: The SME under Globalization Journal of International Marketing, Vol. 8, No.2, Published by: American Marketing Association, pp 12-32.

³⁰ Mitja Ruzzier et, al, (2006), SME internationalization research: past, Present and future, Journal of small business and Enterprise Development. Vol. 13. No 4, Emerald Group Publishing Limited, Available at <http://www.emeraldinsight.com> (Accessed April 7, 2009), pp 476-497.

³¹ Sanjaya Lal, (2000), Strengthening SMEs for International Competitiveness, pp 2-4.

³² WCM, The term was first used by Hayes and Wheelwright (1984) to describe companies that achieved competitive advantage by systematically improving their manufacturing facility-the ability to make it better.

³³ Zulfiqar Khan and Rajeev.K.Bali, (2007), Developing a (Business Process Improvement) BPI framework and (Performance assessment methodology) PAM for SMEs, p 346.

³⁴ Dagmar Recklies, (2001), Small and Medium-sized Enterprises and Globalization, pp 1-2.

For an SME, possessing competitive instinct and willingness for innovation, it has to work in conformity with the agenda of Corporate Social Responsibility (CSR) and Corporate Social Opportunity (CSO). The basic determinants of CSO are innovation in products and services, serving the unserved markets and building new business models. Traditionally CSR was considered to be associated with LSI but now there is a growing concern for their relevance to SMEs. Under the CSR policy the company has to conform with environmental laws and to contribute towards social and economic sustainability. Though ordinarily enacted for LSI, the SMEs are now realizing the potential of complying with CSR and CSO giving them competitive advantage and enhancing their efficiency.³⁵

1.1.2 Significance of an effective legal framework for SMEs

SMEs around the world are in need to implement effective legal frameworks to carry on their business. Globalization and changes in trade frameworks are posing challenges for the SMEs. For competing with these challenges SMEs need to enhance their organizational structure and managerial skills.³⁶ For competing at global level SMEs have to enact legal frameworks and implement work place reforms for the maintenance of their viability.³⁷ In the contemporary world, UK is the pioneer in introducing reforms for its SMEs. In order to enhance the competitiveness of their SMEs the Government has reduced their obligations in respect with complying with labour rights and has granted them fiscal concessions and subsidies. In its long term policy towards SMEs, the UK government is trying to reduce the

³⁵ Heledd Jenkins, (2009), A business opportunity, model of corporate social responsibility for small and medium enterprises, *Business Ethics: A European Review*. Vol 18, issues 1, <http://papers.ssrn.com/sol3/papers.cfm>. (Accessed April 6, 2009), pp 21-36.

³⁶ Lutz Sommer, (2008), Cooperation among SME - The Role of Owner Manager's Attitudes, pp 1-8.

³⁷ Zulfiqar Khan and Rajeev.K.Bali, (2007), Developing a (Business Process Improvement) BPI framework and (Performance assessment methodology) PAM for SMEs, p 345.

barriers of access to capital markets, business advisory services and technological development.³⁸

Rapid globalization demands that SMEs should work within effective legal and trade frameworks. Only in this way they can sustain the pressure induced by LSI.³⁹ Companies around the world are under pressure to incorporate the policies of CSR and CSO within their legal frameworks in order to remain competitive. However originally considered to be a burden, the modern SMEs are realizing that such frameworks are not always a burden but they impart them competitive advantage and ensure more transparency and accountability within the firm.⁴⁰ Enactment and implementation of frameworks will lead SMEs to become world class.⁴¹ The compliance of legal frameworks enhances the capacity of SMEs to raise capital and evaluate firm's management structure along with imparting strong internal and strategic control over the firm's assets.⁴²

1.2 Corporate Governance

Corporate governance is a phenomenon of universal concern in the contemporary world. Corporate governance codes have multiplied and it seems that comparative corporate governance is the new debated issue for the world academics.⁴³ Different scholars have defined it in different ways. Economists view it in perspective of "Agency cost frame", to lawyers it is "Conflict of interest" and politician view it in perspective of "Accountability of

³⁸Sanjaya Lall, (2000), Strengthening SMEs for International Competitiveness, p 14.

³⁹Lutz Sommer, (2008), Cooperation among SME - The Role of Owner Manger's Attitudes, p 2.

⁴⁰Heledd Jenkins, (2009), A business opportunity, model of corporate social responsibility for small and medium enterprises, pp 21-36.

⁴¹ Zulfiqar Khan and Rajeev.K.Bali, (2007), Developing a (Business Process Improvement) BPI framework and (Performance assessment methodology) PAM for SMEs, p 352.

⁴²Shahnawaz Mehmood, (2008), Corporate Governance and Business Ethics for SMEs in developing Countries: Challenges and the way forward, pp 8-9.

⁴³ Klaus J. Hopt, (2000), Modern company law problems: A European Perspective Keynote Speech, Company law reform in OECD countries. A comparative outlook of current trends, Stockholm, Sweden, Available at, <http://www.oecd.org/dataoecd/21/28/1857275.pdf>. (Accessed April 1, 2009), p 3.

management”.⁴⁴ Corporate governance generally means to manage the company in a way to secure the interest of all the stakeholders. Corporate governance keeps a check on the management, imparts transparency in each transaction and secures organizational trustworthiness within a corporation.⁴⁵

Corporate governance is defined by a number of scholars. However according to the majority of them, corporate governance is to frame effective mechanisms and measures for a corporation in order to satisfy the current social expectations along with the expectation of the shareholders.⁴⁶ The most comprehensive definition of corporate governance is given by the OECD, which states that:

“Corporate governance is the system by which business corporation are directed and controlled. Corporate governance specifies the distribution of rights and responsibilities among different participants in the corporation, such as Board of directors (BOD), managers and other stakeholders and spells out the rules and procedures for making decisions on corporate affairs. Thus it provides an overall framework for attaining the objectives of a company and monitors its performance”⁴⁷.

The UK, France and Germany are the pioneers in enacting corporate governance statutes. UK was having the features of free incorporation by 1668, France in 1791 and Germany passed a commercial code in 1861. The rules of corporate governance on international level were first discussed in Cadbury Committee (1992), followed by the Greenbury Committee (1995), Hamble Committee (1998), Higgs report (2003) and by the

⁴⁴ Shaikh Khalid Hussain, (2004), The control of corporation: An analytical study of mechanism employed in non-financial listed firms of Pakistan, PhD Dissertation, University of Karachi, Pakistan, p 18.

⁴⁵ Sanjiv Agarwal, (2003), Corporate Governance concepts and dimension, India: Snow White publications pvt Ltd, pp. 115-123.

⁴⁶ Steve Letza, Xiuping Sun and James Kirkbride, (2004), Shareholding Versus Stakeholding: A critical Review of corporate governance, Journal, Corporate Governance: An International review, Blackwell publishing Ltd, Vol-12, pp 242-254.

⁴⁷ Shaikh Khalid Hussain, (2004), The control of corporation: An analytical study of mechanism employed in non-financial listed firms of Pakistan, p 19.

Organization of Economic Development (OECD) principles.⁴⁸ In USA corporate governance and regulatory corporate frameworks got a new impetus after the famous Enron case. To abridge the deficiencies in their existing laws the Sarbanes Oxley Act 2002 was promulgated. This act contained provisions for making the auditing and filing of financial statements procedures for the companies more transparent and reliable.⁴⁹

International Corporate Governance Network (ICGN) was established in 1995 for developing global policies for the promotion of corporate governance. Its basic aim was to provide a network for exchange of information on corporate governance and to develop and encourage adherence to corporate governance standards and guidelines. Good governance of companies has become important to the world economy. However from developing countries perspective this factor becomes more important as by complying with the principles of corporate governance companies in the developing countries can improve their performance and can get access to the world markets. Corporate governance will lead these countries to attract more foreign investments and will improve their economic performance in the long run.⁵⁰

1.2.1 Approaches towards corporate governance

There are various approaches towards corporate governance due to its holistic nature as it takes into account the overall corporate structure, whether it is from legal point of view, such as company's law, securities regulation, the insider or outsider control of the company

⁴⁸ Building Institution for Market, World development report, (2002), Published by Oxford university press, p 65.

⁴⁹ Christopher Humphrey, Peter Maizer, Stuart Turley, (2006), Independence and competence? A critical questioning of auditing, *Advances in Public Interest Accounting*, Vol 12, Available at <http://www.sciencedirect.com/science/article/pdf> (Accessed August 5, 2009), pp 149-167.

⁵⁰ Robert A.G. Monks and Nell Minow, (2008), *Corporate Governance*, Fourth edition, Jhon Wiley and Sons Ltd, England, pp 352-369.

or the compliance of company with environmental laws. Corporate governance compelled the lawyers to take a new look of various aspects of Corporate Social Responsibility of a company towards its stakeholders and it became a global tool for the companies to get competitive edge in the world economy.⁵¹ Scandals of Enron and WorldCom along with the decline of stock markets at the beginning of new century led to an active debate on corporate governance issues among corporate law professors as for what purpose the corporation exists and whose interests it serves.

Approach towards corporate governance is polarized between two groups. According to the orthodox view of corporate governance, the sole purpose of a company is to maximize the wealth of their shareholders, also called as the Shareholder approach. While the Stakeholder approach is based on the idea that besides maximizing the wealth of its shareholders, the company, being a corporate citizen is under an obligation to fulfill its moral and ethical obligations towards the society. However the approach towards corporate governance in the contemporary world is based on the convergence of the above mentioned approaches also called the pluralistic approach or convergence approach.⁵²

1.2.2 Corporate governance from shareholders' perspective

Shareholder approach or the Anglo-American approach is based on the traditional perspective that corporations are legal instruments for shareholders, to maximize their interests and investment returns. According to this approach, shareholder interest is secured by a three tier hierarchal corporate governance structure within a corporation consisting of

⁵¹ Klaus J. Hopt (2000), Modern company law problems: A European Perspective Keynote Speech, Company law reform in OECD countries. A comparative outlook of current trends, pp 7-8.

⁵² Stephen Letza and James Kirkbride, (2008), Corporate governance theorizing: limits, critics and alternatives, International journal of law and management. Vol 50.No 1, Available at <http://www.emeraldinsight.com/html>. (Accessed April 9, 2009), pp 17-32.

shareholder general meeting, the board of directors and the executive managers. Shareholder model is also called the financial model: it focuses on protection of shareholder rights from financial perspectives and for promulgating an effective system of checks and balances within a corporation.⁵³

The Anglo-American model of corporate governance stresses on accountability of firms because of the massive disaster of their leading companies which proved the ineffectiveness of their existing laws of corporate governance. In the wake of collapse of Enron and WorldCom, US realized that accountability and protection of shareholders rights should be the basic purposes of corporate governance.⁵⁴ A corporation is a legal extension of its owners or shareholders. However this model was criticized by the Stakeholder model of corporate governance, according to which apart from maximizing the wealth of its shareholders a corporation should fulfill its ethical and moral obligations towards its stakeholders and the society.⁵⁵

1.2.3 Corporate governance from Stakeholders' perspective

Stakeholder perspective of corporate governance is having a wider objective. According to it, the function of a corporation is more equitable and socially more efficient than merely maximizing the wealth of its shareholders. It considers the suppliers, employees, customers and managers, long-term association with the firm important for its long term success⁵⁶. This approach is also called as the European approach, which takes into account the broader

⁵³ Steve Letza, Xiuping Sun and James Kirkbride, (2004), Shareholding Versus Stakeholding: A critical Review of corporate governance, pp 242-254.

⁵⁴ Cynthia A. Williams, Richard W. and Marie L.Corman, (2004), The erosion of the Anglo-American shareholder value construct, Available at. <http://www.law.ulca.edu/docs/pdf> (Accessed April 24, 2009), pp 1-5.

⁵⁵ Steve Letza, et, al, (2004) Shareholding Versus Stakeholding: A critical Review of corporate governance, pp 242-254.

⁵⁶Stephen Letza and James kirkbride, (2008), Corporate governance theorizing: limits, critics and alternatives, pp17-32.

objectives of a firm along with its focus on the environment.⁵⁷ According to this approach a corporation is a real rather than an artificial person. Corporations are involved in many aspects of social life and affect many people in both welfare and potential risks: hence it needs to be conscious of its social obligations, such as fairness, social justice and protection of employees. This view is strongly supported by corporate law theory in which corporation is defined as a legal person separate from its owners.

The economy of contemporary world and global competition demands for a process of innovation and quality improvement by a corporation along with considering human resource base as an important element for a firm's survival.⁵⁸ According to the proponents of this theory, the corporate governance enhances the efficiency of a firm in two ways: in first place it enhances the reputation of a firm for its ethical treatment both externally and internally. Their second argument is based on the successful industrial societies of Germany and Japan in which extensive stakeholders are involved and their role is more emphasized than the shareholders profit.⁵⁹ However the emergence of CSR movement gave new impetus to stakeholder approach by persuading for substantive changes in corporate behavior and by promoting expanded information on corporate social and environmental issues. The CSR advocates are pursuing the corporate and legal communities to move from the narrow focused shareholders approach to the broader perspective of stakeholders approach. However among these two approaches a third approach is taking its roots called as the pluralistic or convergence approach.⁶⁰

⁵⁷ Cynthia A. Williams, Richard W. and Marie L.Corman, (2004), "The erosion of the Anglo-American shareholder value construct".pp 12-16.

⁵⁸ Steve Letza, et, al, (2004), Shareholding Versus Stakeholding: A critical Review of corporate governance, pp242-254.

⁵⁹ Stephen Letza and James kirkbride, (2008), corporate governance theorizing: limits, critics and alternatives, pp17-32.

⁶⁰ Cynthia A. Williams, Richard W. and Marie L.Corman, (2004), "The erosion of the Anglo-American shareholder value construct". pp 1-5.

1.2.4 Pluralistic or convergence approach towards corporate governance

Pluralistic approach towards corporate governance is based on the principle that a collective approach is better than a polarized one to understand corporate governance in today's dynamic and complex environments. The advocates of this approach say that by taking into account the current trends of corporate governance it seems that in near future both of the shareholder and stakeholder approaches will merge. They argue that corporate governance is a social rather than a purely economic or mathematical reality. Thus being a social phenomenon, it cannot be isolated from social and other factors like power, legislation, culture and other institutional contexts. According to them corporate governance is a field which is vulnerable to procedural changes with the passage of time, thus limiting the dualistic approach towards it. It suggests that apart from economic logic, corporate governance is shaped by the contemporary political trends, ideologies, legal systems, social conventions, philosophies and methodologies.⁶¹

In modern company law corporation is defined as an independent and permanent entity with clear cut boundaries and with direct control over its employees, suppliers and distribution system. Global markets are making human capital more independent, in which the boundaries of the firms are becoming unfixable. As a result of which the dualistic approach towards corporate governance is losing its ground.

Due to rapid changes in ideological perceptions and trends in world market the split between shareholder and stakeholder approaches is coming to an end. This trend is evident from the fact the Germany and Japan who are the traditional advocates of stakeholder

⁶¹Stephen Letza and James kirkbride, (2008), Corporate governance theorizing: limits, critics and alternatives, pp 17-32.

approach are moving towards the shareholder approach due to pressure of globalization and world wide competition. Hence in the current scenario the pluralistic approach is more acceptable as it is not only shaped by economic rationality and efficiency but is also influenced by politics, ideologies, social conventions and other methodologies. It is a dynamic and flexible perspective of corporate governance which adjusts the practices from both shareholder and stakeholder perspective.⁶²

1.3 SMEs and corporate governance in Pakistan

Corporate governance rules are meant for governing the companies. Generally it is believed that most of the corporate governance laws in Pakistan do not differentiate the companies on the basis of their size, nor is there any specific criteria for applying laws to a particular set of industries. This indiscriminate application of laws makes it difficult for the SMEs to pay the exorbitant taxes and other regulatory charges to the government authorities thus undermining their competitiveness. In this context the UK policies towards their SMEs can be taken as a role model. For encouraging the competitiveness and corporatization of SMEs the UK simplified its laws for the SMEs along with reducing the regulatory burdens on them.⁶³ The need of hour is to encourage the corporatization of SMEs. The Pakistani corporate governance laws should grant relaxation to the SMEs. As currently SMEs in Pakistan because of their small size and operating on local scale do not follow corporate governance laws. However these are the industries which are more vulnerable to malpractices like violation of labour rights, child and bonded labour practices and corporate crimes, as they are not liable to comply with corporate governance laws being functioning

⁶²Steve Letza, et, al, (2004), Shareholding Versus Stakeholding: A critical Review of corporate governance, pp 242-254.

⁶³ Sanjaya Lall, (2000), Strengthening SMEs for international competitiveness, p 14.

beyond their jurisdiction. SMEs are the backbone of the economy of the developing countries and corporate governance rules of equal importance for the SMEs, as it provides them a strong institutional setup and a mechanism to solve their financial, technological and marketing problems.

Due to immense importance of corporate governance, industrial relations scholars are focusing on the relationship existing between corporate governance, ownership and employment relations.⁶⁴ Corporate governance addresses the micro-economic issues of corporations, firms and their relationship with managers, banks and equity markets. In its broader perspective corporate governance addresses the whole lot of issues faced by the LSI and SMEs.⁶⁵ However by taking into account the ratio of manual labour in SMEs it can be stated that such laws are more relevant to them, rather than to the LSI, where manual labour is not in abundance.⁶⁶ Corporate governance got importance for SMEs in the developing world because the LSI in these countries failed to improve the improvised economic conditions of the masses.⁶⁷

In Asian countries attention towards corporate governance was diverted after the Asian crises in 1997. About the prevalent corporate governance in Asia it is stated:

“Asian conglomerates are too unfocussed, too poorly managed and structured, lack transparency and are devoid of internal checks and accountability. There is not such a thing

⁶⁴ Andrew Pendleton and Simon Deakin, (2007), Corporate governance and workplace employment relations: the potential of WERS 2004, *Industrial Relations Journal* 38:4, Blackwell publishing Ltd. Available at, <http://interscience.wiley.com/pdf>. (Accessed April 4, 2009), pp 338-355.

⁶⁵ Haider. A. Khan, (2003), corporate governance: The limits of the principle agent approach in the light of family based corporate governance system in Asia, Available at <http://www.e.u.tokyo.ac.jp/cirje/research/dp/2003/2003cf230pdf> (Accessed July 23, 2008), p 3.

⁶⁶ Employment and Development of Small Enterprises Sector policy paper, (1978), World Bank, p 18.

⁶⁷ Malcom Harper, (1985), *Small Business in the third world*, p 7.

as an Asian way in the global age, just a right way and a wrong way and the Asian way is the wrong way.”⁶⁸

According to the corporate governance scholars, governance is an important tool for imposing discipline and providing leadership for poorly managed firms.⁶⁹ The SMEs can take the benefits of corporate governance by complying with these laws, which will solve their problem of access to resources for growth. Corporate governance laws require the appointment of non-executive directors to the firm. These non-executive directors are agents of innovation and introduce creativity by giving suggestion and opinions. In Japan the SMEs with high growth rates are the ones having a large number of non-executive directors on their boards.⁷⁰

In a nutshell it can be stated that in the contemporary world smallness of a business is not a barrier to its competition on the international level. Modern day businesses are global by nature and there are enormous opportunities for the local SMEs to compete outside their domestic market. Mutual cooperation, alliance, sharing and interdependence are the business strategies in the global world. Hence SMEs cannot develop superior products and face the complexity and risks of modern economy in isolation.⁷¹ For becoming a part of international business networks and enhancing their export capability, SMEs are in need to act within legal frameworks and to abide by their respective codes of corporate governance.

⁶⁸ Micheal Becjman, (1999), *Asian Eclipses exposing the dark side of business in Asia*, Jhon Wiley and sons: Asia, Ltd, p 65.

⁶⁹ Sanjai Bhagat, Brain Bolton, (2007), *Corporate Governance and firms performance*, Available at, <http://w4.stern.nyu.edu/empllibrary/bhagat.paper.revised.pdf>. (Accessed April 26, 2009), pp 3-6.

⁷⁰ Joshua Abor, Charles K.D Adjasi, (2007), *Corporate governance and the small and medium enterprises theory and implications*, pp 111-122.

⁷¹ Risto Rajala, (2008), *SME business models in global competition: a network perspective*, *International Journal of Globalisation and small Business*, Vol 2, No.3, Inderscience Enterprises Ltd. Available at <http://www.inderscience.com/pdf> (Accessed date April 26, 2009), pp 342-355.

1.3.1 SMEs and corporate governance from Islamic perspective

Islam is a dynamic religion. It covers every aspect of human life. The concept of business responsibility given by Islam is much wider and broader than the one given by the western scholars or the scholars of the materialistic secular world. The secular business scholar separates economics from ethics, gives preference to economic values over spiritual values and prefers legal and bureaucratic mechanism over moral and ethical values in compliance with the principles of business responsibility. They are of the view that enterprises conduct their business in moral vacuum. It was due to their narrow problem solving methodologies that Enron and WorldCom like disasters occurred inspite of their efficient corporate laws mechanisms, which excluded the moral and ethical dimensions during the process of solving the business related social problems.

Islam does not separate politics and religion, economics and ethics, religious and secular affairs. For formulating business responsibility frameworks Islam takes into account the spiritual values of justice, peace, righteous, stewardship and community. According to Islam:

“There is a need to cultivate a higher-consciousness, morals and a sense of accountability to a higher being (God) as a pre-requisite. Since it develops an inner respect for social values and laws.”

Islam contends that any law which lacks moral and ethical aspect will lead to practices of injustice in business and society. The basic guiding Islamic principles for formulating a framework for corporate governance and social responsibility is to give due consideration to long term business practices, while keeping involved all the stakeholders groups in decision making process. It argues for the development of an organizational community fostering a climate of spirituality and ethical behavior and responsibility within

an organization. Apart from legal mechanisms, appeal should be made to the inner-spiritual resources to implement business responsibility policies within a corporation.⁷²

Islamic concept of business ethics resembles the globally debated CSR movement. The concept of CSR given by Islam is much wider than the CSR of the western world. The three basic domains of CSR in Islam are the stakeholders, the natural environment and general social welfare.⁷³ Islam sets high standards of development of human capital and transparency requirements in business transactions along with a specific enforcement mechanism. The conformity between Islamic ethical business standards and CSR as stated by the UN global compact program⁷⁴ is very encouraging as it shows the convergence between the modern stakeholder capitalism and Islam.⁷⁵ Hence the following of corporate governance laws in SMEs is a religious obligation of the enterprises, apart from being an ethical and legal obligation.

1.3.1 Corporate governance and SMEs problems

SMEs around the world and particularly in the developing countries are in need of access to capital resources, technology and offshore trading. Most of the SMEs are performing well on their domestic and local level. However for competing in the world market SMEs need to comply with their local, national and international corporate governance requirements. In

⁷² Zahid Parvez, (2007), Lack of business ethics from Islamic perspective, International Journal of Business Governance and Ethics (IJBGE), Vol. 3; No. 1, Available at <http://www.inderscience.com/pdf>. (Accessed April 24, 2009), pp 42-53.

⁷³ Dr Rafik Issa Beekun, (2005), An Islamic Business Ethics: Book Review, International Institute of Islamic Thought, Available at [http://www.dinarstandard.com/mangment/ethics & books review.html](http://www.dinarstandard.com/mangment/ethics%20&%20books%20review.html). (Accessed May 3, 2009), pp 1-6.

⁷⁴ The principles of UN global compact, deals with human rights, labor rights, environment and anticorruption practices, within an organization.

⁷⁵ John Zinkin and Geoffery Williams, (2009), Islam and CSR: A study of compatibility between the tenets of Islam and the UN Global Compact, Journal of Business Ethics, Available at <http://www.springerlink.com/content/l68pw6605r967101/fulltext.pdf> (Accessed August 10, 2009), pp 1-8.

this context SMEs need effective implementation of corporate governance laws in order to fully utilize their potential along with addressing the challenges of globalization.

The presence of strong corporate governance institutions in a country helps in growth of SMEs and entrepreneurial culture, as it address the whole host of issues faced by the SMEs. Corporate governance institutions include the whole mechanism like board of directors, corporate and bankruptcy laws and labour regulatory practices. Well functioning governance institutions help the SMEs to invest their resources and make an environment where the profits earned are shared among the investors, managers and employees.⁷⁶ Corporate codes elaborate firm's responsibility towards the environment. A moral standard, in corporate governance is a combination of mental, social and corporate principles, being based on individual, workgroup and company values.⁷⁷

Corporate governance provides a panacea for SMEs problems it aims to fulfill the long term strategic goals of the owners, along with maintaining good business management and giving full protection to stakeholder rights. It argues for the compliance of full legal requirements of all the regulatory practices and appointment of auditors by the firm. Only then SMEs will be able to gain a competitive advantage and an excellent corporate identity making it more attractive for the investors.⁷⁸

Corporate governance assumes more importance for a developing country like Pakistan due to its transitional nature of corporate structure and abundance of SMEs. The role of multiple and minority shareholders, lack of transparency in auditing, access to finance and technology are the major problems in Pakistani SMEs sector. Besides other regulatory

⁷⁶ Building Institution for markets. World Development report, (2002), Oxford University Press, pp55-74.

⁷⁷ Aat Brakel, (2007), The moral standard of a company: performing the norms of corporate codes, International journal of Business Governance and ethics, Vol 3. No. 1, Available at <http://www.inderscience.com/storage.pdf>. (Accessed April 24, 2009), pp 95-103.

⁷⁸ Nigel Kendall, Arthur Kendall, (1998), Real-World corporate governance, Pitman Publishing, pp 72-77.

bodies, SECP in Pakistan provides an institutional building for corporate governance.⁷⁹ The code of corporate governance drafted by SECP gives a checklist of voluntary and mandatory provisions for the companies thus making its compliance easy for the companies.

Corporate governance laws in Pakistan are at transitional stages. Currently most of these are left to the willingness of the companies, however this trend is having a drastic impact upon the SMEs by not abiding by it. Apart from this it contains certain lacunas regarding its implementation. It lacks penal provisions and active monitoring by SECP accompanied by weak legal system, where it becomes quite cumbersome for the minority shareholders to enforce their rights. Another shortcoming is that corporate governance laws in Pakistan are still fragmented, though the code of governance is there but still some of its provisions like protection of minority shareholder are still dealt by the Companies' Ordinance. Similarly Pakistan lacks a strong financial media which play a leading role in promoting good corporate governance practices.⁸⁰ Another loophole in our corporate governance laws is that most of the labour laws are applied to sizeable establishments. Similarly labour regulations cannot be effectively enforced against the SMEs. Because most of the labour force employed in SMEs comes under the definition of temporary labour, this is the category of labour force not protected by the current labour laws of Pakistan adequately.⁸¹

For the promotion of entrepreneur culture and high level of development and growth, business friendly policies and regulatory environment is important. However the regulatory practices of corporate governance in Pakistan are not very conducive for SMEs

⁷⁹ Rasul Baksh Rais and Asif Saeed, (2004), Regulatory assessment of SECP corporate governance code in Pakistan, Corporate governance CMER papers, LUMS, Available at www.eaber.org/intranet/documents/113/.../LUMS_Rais_2005.pdf. (Accessed March 29, 2009), pp 1-4.

⁸⁰ Haroon. H. Hamid and Valeria Kozhich, (2006), Corporate governance in an emerging market: A perspective on Pakistan. *Journal of Legal Technology Risk Management*, Vol.1.No 1.pp 22-31.

⁸¹ Faisal Bari, Ali cheema, Ehsan-ul-Haque (2005), SME Development in Pakistan: Analyzing the constraints to growth, Working paper No 3, Asian Development Bank, p 37.

growth. Though SMEs in Pakistan are in a large number but they have been denied of extra bargaining power to influence the corporate governance policies to promote their interests, due to which most of the SMEs have no access to state institutional resources.⁸² Thus undermining their development and growth.

By considering the state of SMEs in Pakistan it can be stated that Pakistani SMEs need the formulation and implementation of an effective legal framework of corporate governance to address their contemporary challenges. However it is important to change the attitude of SMEs owners towards corporate governance, that the compliance of such laws enhances their performance. Similarly the government should also reassess their policies for SMEs. The main grievance of SMEs owners against present corporate laws of being a costly affair should be addressed. The laws relating to SMEs should be made simplified so that it should become a stimulant for voluntary compliance by these industries. It's high time to raise awareness among the SMEs owners that the following of corporate governance laws can solve their problems.

⁸² Shahab Khawaja, (2006), Unleashing the potential of SME sector with focus on productivity improvements, Available at <http://www.sitersources.worldbank.org/pak>. (Accessed April 2, 2009), pp 4-5.

Chapter 2

Contemporary problems of SMEs in Pakistan

This chapter gives a brief overview of the problems faced by the SMEs in Pakistan. Pakistan is a developing country and SMEs play a crucial role in the economy of developing countries. As these countries are running short of capital and lack access to modern technology hence the SMEs are the best alternate for addressing such economic problems as they are efficient utilisers of locally available raw material and employ the locally available abundant labour force. These are suppliers of goods to the local market and some advance SMEs are a good source of foreign exchange earnings. The SMEs in Pakistan are playing a positive role in its economic uplift. However SMEs in Pakistan present a dismal picture if compared with the performance of SMEs on regional and international levels.

The contemporary problems faced by SMEs in Pakistan are multi-dimensional. They lack access to capital and scientific know-how for modernizing their businesses. The procedure for obtaining export licenses by them is quite cumbersome as a result of which most of the SMEs are contented with selling their products in the domestic market. SMEs of Pakistan are mostly blamed for unfair labour practices and in foreign countries their goods are boycotted on this pretext. From the last one year the whole country is in grip of power supply shortage and SMEs are worst affected as most of them have to remain closed due to frequent load shedding and power supply breakdowns. Heavy taxes, bureaucratic burdens and biased tariff policies are the further impediments in the growth of SMEs in Pakistan. The current wave of political instability and poor law and order situation has further undermined the development of this sector.

In order to utilize the enormous potential of SMEs the government needs to address its problems from the grass root level. Mere granting of a few incentives is not the appropriate

remedy. Changes should be introduced at the policy making level to make the business environment conducive for the flourishing of entrepreneurial culture throughout the country. SMEs should be encouraged to comply with the corporate governance practices in order to become more vibrant and internationally competitive. This chapter briefly analyzes the contemporary problems faced by the SMEs in Pakistan.

2.1 Financial problems

Limited financial resources are the major restraint upon the SMEs growth in developing countries. Industries require huge amount of capital, along with government support in the form of incentives and flexible regulatory policies. Unfortunately, SMEs in Pakistan are mostly suffering from shortage of capital, facing the problems of costly credit financing,⁸³ leasing and are passing through a cumbersome procedure for getting export license. These problems are briefly analyzed as follows.

2.1.1 Access to credit

Finance oils the wheel of industrialization in an economy. Availability of finance plays a decisive role in the successful operation of an enterprise. Most of the SMEs are financed by the owner and his partners rather than through banks or other financial institutions. This mode of financing is named as informal financing which can solve the financial problems of the industries only on a limited scale. On the other hand formal financing through banks and other financial institutions ensures the availability of huge financial resources with limited risk and more transparency and accountability. The availability of finance for SMEs is a topic of interest for the world academics and an important issue for the policy makers throughout

⁸³ S. Akbar Zaidi, (1999), Issues in Pakistan Economy, Oxford University Press, pp 131-133.

the world. The availability of finance for SMEs is affected by the lending technologies, government policies and financial institutional structures within a state. Most of the large institutions and banks finance companies on the basis of transaction lending (Which means the supply of fully audited financial statements along with full records of the company assets), while the SMEs are unable to full fill this criteria so they have to resort to the relationship lending and to the informal modes of financing. The informal financing despite certain benefits do not provide effective funding required by the SMEs.⁸⁴

According to the policy makers and international aid organizations, the SMEs in developing countries are having inadequate access to external finance due to market imperfections. The use of informal finance hardly meets their requirements and they cannot access to the institutional finance due to their institutional underdevelopment.⁸⁵ Consequently, most of the SMEs in developing countries are short of capital. They are hindered from seeking assistance from the formal institutions due to their practices beyond the codes of corporate governance and legal frameworks, which impart transparency to their financial statements and enhance their image in the corporate world.

The SMEs in Pakistan like the SMEs of other developing countries require access to finance via investment. As stated earlier investment in Pakistan SMEs mostly come from personal savings of the entrepreneur or through informal means such as borrowing from friends,

⁸⁴ Lending technology is defined as a complete set of information about the state of affairs of a company ranging from underwriting policies to the whole monitoring mechanism.

Lending technology is broadly classified into two categories: one is transaction lending which requires complete audited financial statements along with full record of company assets. The other is relationship lending which extends loan on soft basis and do not take into account the qualitative information of a company. For the SMEs relationship based lending is more convenient as most of them function beyond the ambit of corporate governance. Allen N. Berger and Gregory F. Udell, (2006), A more complete conceptual framework for SME finance. *Journal of Banking & Finance*, Available at <http://www.sciencedirect.com/science> (Accessed May 8, 2009), pp 2945-2966.

⁸⁵ Thoresten Becka et al, (2008), Financing patterns around the world: Are small firms different, *Journal of financial Economics*, Vol 89, Issue 3, Available at <http://www.sciencedirect.com/science/article/pdf>. (Accessed May 6, 2009), pp 467-487.

relatives or by forging partnerships. Though there are a number of financial institutions,⁸⁶ yet due to lack of financial data it is difficult to give the exact figure as to what extent these institutions are contributing towards fulfilling the financial needs of the SMEs. According to the United Nation Industrial Development Organization (UNIDO) in 1981 only two percent of Pakistani SMEs were provided with bank financing.⁸⁷ SMEs in Pakistan are usually reluctant to give exact data⁸⁸ of their financial performance however the available data analysis in Pakistan shows that the SMEs which maintain bank accounts are comparatively more successful.⁸⁹

In Pakistan the credit related problems act as a binding constraint on the SMEs. The main difficulties in this regard are lack of access to credit, collateral requirements of banks and other financial institutions, lack of connections with banks; delays in loan financing process and corruption in obtaining finances. Most of the SMEs in Pakistan follow the Pecking Order theory⁹⁰ of financial choices, as a result of which 50% fixed investment finance is through self financing practices and only 6% finance comes from banks and financial institutions. In Pakistan banks are reluctant to extend loans to SMEs due to their small size and their practice of not following the auditing and accounting procedures, thus considered by the banks as risky investments. The low demand of credit in SMEs does not mean that they are not in need of access to credit but it is the firm size related constraints

⁸⁶ Financial institutions in Pakistan lending to SMEs include the commercial banks, the small industrial corporation, Industrial development Bank of Pakistan and the small business finance corporation, accompanied recently by SME Bank and SMEDA.

⁸⁷ Muhammad Saleem Bhutta, (2000), Engineering Sub-contracting and Enterprise Development in Pakistan, PhD thesis, Bahauddin Zakriya University, Multan, Pakistan, pp 16-17.

⁸⁸ There is a trend in Pakistani SMEs not to share data with strangers on the basis of profits earned, which will make them liable to pay exorbitant taxes to the government regulatory authorities. Arif Iqbal Rana and Usman Asad, (2007), SME pulse Entrepreneurship & Small and Medium Enterprise Center (ESMEC) A survey report on the health of SMEs in Pakistan, p 19.

⁸⁹ Ibid, p 35.

⁹⁰ Pecking order theory means that the firm tries to be financed by its own funds, if the capital is short then it resorts to debts and finally by listing its shares. Faisal Bari, Ali Cheema, Ehsan-ul-Haq, (2005), SME Development in Pakistan, Analyzing the constraints to growth, Pakistan Resident Mission Working paper Series No.3, Asian Development Bank, p 22.

that are restraining SMEs from formal modes of financing.⁹¹ In the light of above statistics it can be stated that there exists a gap between SMEs and the financial institutions⁹² in Pakistan as a result SMEs' access to credit related problems is further aggravated.

2.1.2 Access to export finance

In this era of globalization and free market economy export of goods to the regional and international markets plays a significant role in determining the economic strength of an enterprise. Export of goods to foreign markets brings finance and boosts the image of the SMEs on international level. Access to export finance on flexible terms stimulates the export capability of the SMEs.

The importance of export in international trade has tremendously increased in the recent years.⁹³ The literature regarding export barriers to SMEs is somehow confusing and different authors have listed different barriers according to their economic orientation. The studies conducted in USA, UK and Canada in this regard reveal that the most important export barriers to SMEs are inefficient finance, lack of foreign market connections, different safety and quality standards, foreign government restrictions and inefficient knowledge of

⁹¹ Ibid, pp 21-25.

⁹² This gap is retarding the growth of SMEs. Its importance can be realized from the fact that the Asian countries after the Asian crises, are trying to reduce the existing gap between their financial institutions and their SMEs, in order to equip them for international market competition. Deeshka A. Singh, (2009), Export performance of emerging market firms, *Journal of International business review*, Available at, <http://www.elsevier.com/locate/ibusrev> (Accessed May 7, 2009), p 1.

⁹³ As according to World Bank 2003, Global export trade contributes to about a quarter of world's GDP. Deeshka A. Singh, (2009), Export performance of emerging market firms, *Journal of International business review*, pp 1-5.

foreign regulatory practices.⁹⁴ From the developing countries perspective their export market strategy regarding SMEs faces both external and internal barriers.⁹⁵

Access to export finance is an issue for the SMEs in Pakistan. The economy of Pakistan is encountered by the problem of trade deficit.⁹⁶ As the LSI are few and most of the SMEs lack the capacity of exporting their goods, due to scarcity of capital, lack of technology and non-compliance of currently promulgated ISO standards⁹⁷ and other regulatory practices. That's why the contribution of SMEs export earnings to the total GDP is not very encouraging.

In Pakistan around 95% of SMEs sell their products in the domestic market.⁹⁸ Export finance is issued to the SMEs having export letter of credit⁹⁹, thus compelling most

⁹⁴ The research concludes that due to the aforementioned issues the SMEs usually accord low priority to export promotion activities. Mujahid Ali, (2000), Export behavior of small and medium enterprises, PhD thesis Bahauddin Zakaria University, Multan, Pakistan), pp 90-91.

⁹⁵ Internal barriers include marketing knowledge and information, financial and human resources, product quality and technical adaptability. External barriers include industry structure, competition, customer barriers, and procedural barriers. Goitom Tesfom and Clemens Lutz, (2006), A classification of export marketing problems of small and medium sized manufacturing firms in developing countries, International journal of emerging markets, Vol 1. No 3, Available at <http://www.emeraldinsight.com/Insight/ViewContentServlet?Filename=Published/EmeraldFullTextArticle/Articles/3010010306.html> (Accessed May 8, 2009), pp 262-282.

⁹⁶ A situation when the imports of goods from foreign countries exceed its exports capacity. Most of the developing countries face this problem due to their weak industrial set up, they have to rely on foreign goods, which proves to be a costly phenomenon. Lower export earnings increases trade deficit. In Pakistan per month trade deficit is around 2 billion.

⁹⁷ One of the major challenges of low income countries enterprises is to comply with the buyers' requirements of quality, social, environmental and safety standards. For example ISO 9000 quality management standard enables the enterprise to increase its profitability and customer satisfaction. Further details are available on http://www.smeda.org/Guidelines-for-SMEs-on-Compliance-and-ISO-Certification_291.html (Accessed March 23, 2009), pp 1-3.

⁹⁸ M. Kurrum S. Bhutta, Arif I Rana and Usman Asad, (2007), SCM practices and the health of the SMEs in Pakistan, Supply chain management an international journal, Available at <http://www.emeraldinsight.com/Insight/viewPDF.jsp?contentType=Article&Filename=html/Output/Publiched/EmeraldFullTextArticle/Pdf/1770120606.pdf> (Accessed May 8, 2009), p 412.

⁹⁹ Letter of credit is a contract of a firm with a financial institution, in which the financial institution takes the liability of payments for the seller or purchaser in case of his default. The financial institution issues such letter of credit to the LSI because according to them, their financial statements depict the true state of affairs of such enterprises. Mansoor Hasan siddique, Allaudin Achakzai, Farzand Ali, (2008), SME Finance quarterly review, First Quater, Issues 2, Available at <http://www.sbp.org.pk/sme/PDF/QReview/QReview-Mar-08.PDF> (Accessed August 10, 2009), pp 1-5.

of them to be indirect exporters.¹⁰⁰ SMEs share in the export earnings of Pakistan is 25%. The underlying reasons of such low export earnings are the demand and supply issues, flow of credit, lack of reliable information and documentation, human resource constraints, collateral lending, SMEs reluctance to disclose their financial position and Bank perception of considering SMEs as higher risk customer.¹⁰¹ Lack of government Contribution is another impediment¹⁰² in promoting export related activities for SMEs in Pakistan.

2.1.3 High costs of credit and leasing

The availability of finance on low cost and easy terms and conditions plays a significant role in the flourishing of SMEs and entrepreneur culture within a country. Leasing and access to credit are important techniques of SMEs financing. A financial institution plays an effective role in the availability of loans and in financing firm's projects. The basic grievance of SMEs against these institutions is that they charge exorbitant interest on the loan and credit extended. As a result of which most of the SMEs are reluctant to take loans from these financial institutions.

A high rate of interest on the credit advanced by the lending institutions to SMEs is a financial impediment in its growth.¹⁰³ In Pakistan access to finance for SMEs is marked by high rates of interest, which is gradually increased in each financial year,¹⁰⁴ thus acting as a binding constraint on its growth. The basic reason behind these increasing interest rates is

¹⁰⁰ Faisal Bari, et. all, (2005), SME Development in Pakistan, Analyzing the constraints to growth, Pakistan Resident Mission Working paper Series, p 29.

¹⁰¹ Governor, Syed Salim Raza, SME credit guarantee facility in offing, The News International February 28, 2009, Available at http://www.dailytimes.com.pk/default.asp?page=2009%5C02%5C28%5Cstory_28-2-2009 (Accessed August 10, 2009), pp 5-11.

¹⁰² S. Akbar Zaidi, (1999), Issues in Pakistan Economy, Oxford University Press, p 133.

¹⁰³ World Bank, (1978), Sector policy paper Employment and development of small enterprises, p 21.

¹⁰⁴ The interest rates of Banks increased from 3% during 1980 to around 8% by the end of the millennium. In the FY 2001 it was around 6% and according to FBS report 2002 interest rate is 14% and in 2009 FY the interest rates are cut down by the government to 12%. Faisal Bari, et. all, (2005), SME Development in Pakistan, Analyzing the constraints to growth. Pakistan Resident Mission Working paper Series, p 27.

the extension of nonperforming loans by Banks and the charging of advance taxes. Though the government is trying to decrease these high cost interest rates but still on Asian level Pakistan is the country charging high interest costs on the credit advanced to its SMEs. This trend is deterring people from investing in entrepreneurship.¹⁰⁵

Another problem related with high interest rates is high costs of leasing. SMEs unable to purchase machinery and equipments resorts to lease financing. Around the world lease financing is an important business. It got immense importance due to its technique of asset based lease financing, in which profits are earned on the basis of use of assets rather than on the basis of ownership, along with payment of the leasing rent. Due to this advantage the developed countries have made flexible policies for promoting lease financing practices. However the developing countries still lag behind in removing the impediments in making leasing, as a mode of finance for their SMEs. From Shariah perspective, leasing is an important mode of financing, if drafted according to rules of Shariah.¹⁰⁶ However in Pakistan lease financing for SMEs is not very common. The basic impediments in the way of lease financing for SMEs is the high cost of leasing and the SBP collateral regulations.¹⁰⁷ For solving the financial problems of SMEs, the government needs to adopt flexible policies for the SMEs and relax the procedural requirements, as is done in UK by giving the concept of "Think small first".¹⁰⁸

¹⁰⁵ Faisal Bari, et. al, (2005), SME Development in Pakistan, Analyzing the constraints to growth. Pakistan Resident Mission Working paper Series, pp 27-29.

¹⁰⁶ Lease financing is more suitable for the SMEs as it does not obliges its borrowers by taking additional securities nor it requires land mortgages. It is due to its immense importance that 75% of the world leasing business is owned by the top five economies of the world. Hamayun Murad, (2003), CEO Orix leasing. Leasing- path to a prosperous SME sector. Available at http://www.sbp.org.pk/bpd/Conference/Day_One/Leasing%96Path_to_prosperous_SME_sector.pdf (Accessed June 6, 2009), pp 1-8.

¹⁰⁷ Faisal Bari, et. al, (2005), SME Development in Pakistan, Analyzing the constraints to growth, Pakistan Resident Mission Working paper Series, p 28.

¹⁰⁸ Modern Company Law, (2000), For a competitive economy developing the framework, A consultation document from the Company Law Review Steering Group, p 221.

2.1.4 Taxation burdens

Taxation and payment of other regulatory charges is a financial burden on Pakistani SMEs. Generally the taxation authorities make no discrimination in the SME and LSI regarding imposition of taxes. This equal treatment of SMEs with the LSI acts as a financial burden on SMEs. The economies of UK and US¹⁰⁹ are LSI oriented: inspite of this their policies towards SMEs are flexible and make a distinction between the LSI and SMEs regarding payment of taxes.¹¹⁰ UK gives maximum support to its SMEs on tax related issues for making them more competitive. UK policy makers have simplified the regulatory procedures for SMEs in the field of taxation, while granting subsidies and other fiscal concessions to them.¹¹¹

SMEs in Pakistan are encountered by a complicated taxation administrative set up. It is argued that the current tax payment setup does not grant SMEs any incentives on the basis of their size and they are under constant threat of regulatory authorities. Unlike the LSI they cannot afford to maintain properly audited statements and fulfill other professional requirements. Similarly the prevailing taxation system is discretionary, granting enormous powers to the tax authorities. The provincial taxation set up of Pakistan is quite opaque, which results in constant controversies between the taxation authorities and business communities.¹¹²

¹⁰⁹ US has promulgated the US Small Business Regulatory Enforcement Act of 1996 for giving preferential treatment to their SMEs in matters of tax related issues. Shahab Khawaja, (2005), CEO SMEDA Unleashing the potential of SME sector with a focus on productivity improvements, <http://www.sitersources.worldbank.org/Pakistan> (Accessed April 2, 2009), p 10.

¹¹⁰ According to the Investment climate survey in 2001, the smaller firms are facing the tax related more severely then the large firms, Ibid, pp7-8.

¹¹¹ Sanjaya Lall, (2000), Strengthening SMEs for International Competitiveness. Available at <http://www.worldbank.org/mdf/mdf3/papers/firm/lall.pdf> (Accessed April 5, 2009), pp7-8.

¹¹² According to data analysis 67% of the SMEs reported that the tax regulations are cumbersome for them, 56% stated that taxes are increasing their financial difficulties and according to 28% the prevailing taxes are exorbitant for the SMEs to pay. Developing SME policy in Pakistan, SME issues paper- for deliberation by

In Pakistan the taxation structure depicts bureaucratic trends and extra regulatory burdens. There is a lack of a fixed coherent tax policy, as currently there are around sixty tax related laws in the country. This uncertainty and inconsistency of policies is breeding corruption, as under the current taxation structure the concerned lower staff uses their discretionary powers for harassing the SMEs owners increasing their fiscal burdens.¹¹³ Tax is imposed by the governments for generating revenue and promoting economic growth within the country. However in Pakistan it is a factor hampering the growth of entrepreneur culture. So the need of hour is to devise a taxation policy granting some concessions and incentives to the SMEs, as they are not financially strong like the LSI of the country and cannot afford exorbitant tax rates.

2.1.5 Tariff policies

Tariff policy is a technique used by the governments for protecting the SMEs and other infant industries from direct foreign competition. Tariffs, grant of subsidies, quota, and anti-dumping duties are the tools of trade policy.¹¹⁴ The issue of tariffs is a contemporary hot debated issue in various WTO meetings among the developed and developing countries. The developed countries are in favor of free trade and are arguing for elimination of all the tariff barriers. While the developing countries want to retain the right of imposing tariffs on their imports, as according to them their infant industry cannot face direct foreign competition.

SME Task Forces- policy planning & strategy department. SMEDA, Available at http://www.smepolicy.net.pk/SME_Issues/pdf (Accessed June 7, 2009), p 7.

¹¹³ Faisal Bari, et. all, (2005), SME Development in Pakistan, Analyzing the constraints to growth, Pakistan Resident Mission Working paper Series, p 40.

¹¹⁴ Tariff is "a tax levied on imports". Similarly subsidies are given in form of grants, low interest rates and tax breaks to the infant industries, mostly by the developed countries. Charles W.Hill, (2004), Global Business today. Newyork USA.Mc GrawHill, pp 173-174.

US is the major advocate of promoting free trade and argues for the elimination of all trade related barriers. The importance of tariffs for the developing industry can be judged from its own policy of high tariffs on imports of textile products. The general tariff rate of US is 4%, but on textile imports it imposed a tariff rate from 12% to 14%.¹¹⁵ The textile sector accounts for 60% of export earnings to Pakistan.¹¹⁶ This industry uses a variety of locally produced and imported dyes, synthetic fibers and manmade fibers. The demand of blended fabrics is on increase in the world market, which is made from manmade fibers not produced domestically in Pakistan. For boosting the export capacity of the textile sector, the government should try to impose zero tariff duties on import of blended fabrics raw material and high tariffs on synthetic fibers which will increase the marketing of the local producers.¹¹⁷ Generally in Pakistan industrial sector, SMEs are often constrained by the high tariff rates on imported raw material and the relative low tariff on furnished products.¹¹⁸

Tariffs are of various kinds, but from the perspective of SMEs in Pakistan they can be divided into two major categories: tariff on imported raw materials and tariff on imported furnished products. For enhancing the export capability of the SMEs the government should gradually reduce tariffs on import of raw material and increase the tariffs on imported furnished goods. This policy will make the raw material available for SMEs on cheaper rates. Thus helping SMEs to have a strong hold in their domestic market. By adopting this

¹¹⁵ The US restrained around 46 countries from trading in textile and apparel, while sparing just a few. The underlying motive of this policy was to enable its own textile industry to flourish.

Clinton Stack, (1993), NAFTA and its sectoral impact on Pakistan textile and apparel. Economic review. Available at <http://www.encyclopedia.com/doc/1G1-13797141.html> (Accessed 7 June 2009), pp 1-2.

¹¹⁶ Mujahid Ali, (2000), Export behavior of small and medium enterprises, PhD thesis, Bahauddin Zakaria university Multan Pakistan, p 16.

¹¹⁷ The manufacturing of blended fabrics requires advanced scientific and technological skills and is sold in the world market as the most expensive fabric. Musleh uddin and Ijaz Ghani, (2004), Science and technology based industrial vision of Pakistan's economy and prospects of growth: The case of Textiles and Leather. Available at: <http://www.pide.org.pk/pdf/psde20AGM/Science%20and%20Technology%20based%20Industrial%20Vision%20of%20Pakistan%E2%80%99s%20Economy%20and%20Prospects%20of%20Growth%20The%20Case%20of%20Textiles%20and%20Leather.pdf> (Accessed June 7, 2009), p 8.

¹¹⁸ Faisal Bari, et. al, (2005), SME Development in Pakistan, Analyzing the constraints to growth. Pakistan Resident Mission Working paper Series, p 43.

measure the local domestic industries and the infant industries will be saved from direct competition with foreign goods. Due to the liberal trade policies on tariffs the local markets of Pakistan are flooded with foreign products available at low prices, especially Chinese products, thus manipulating the marketing of SMEs domestically. Hence imposition of tariffs on imported goods is a technique for addressing the problems of SMEs in the long run.¹¹⁹

2.2 Human resource problems

Human resource issue includes in its ambit the whole host of issues like violation of labour rights, child labour and bonded labour practices. SMEs in Pakistan are often blamed for violation of the basic human rights and are particularly criticized worldwide for child labour practices. The general prevailing conception in SMEs is that being functioning on local scale and of small size they are not bound to abide by the state labor laws as the labour laws do apply only to the sizeable organizations. The Factories Act, 1934 enacting provisions for the safety of workers is applied to establishments employing ten or more workers. Similarly the West Pakistan Industrial and Commercial employment (standing orders) is obliged by the establishments employing twenty or more workers.¹²⁰ This conception has led to the violation of basic human rights in these enterprises, which led several countries to boycott their products. The lack of qualified and skilled personnel in Pakistan SMEs is another human resource constraint on the SMEs. These issues are discussed briefly as follows.

¹¹⁹ Ibid, p 43.

¹²⁰ Muin-ud-din Ahmed Khan, (1998), Labor administration profile on Pakistan, International labour organization Asia and Pacific regional center for labor administration (ARPLA) Bangkok. Available at <http://books.google.com> (Accessed June 21, 2009), pp 31-34.

2.2.1 Violation of labour rights and international pressure

The practice of viewing SMEs from Human Right Management (HRM)¹²¹ perspective got importance from the end of last decade. HRM factor determines the reputation of the firm in the contemporary world.¹²² According to the regulations of ILO and UNIDO firms are under an obligation to provide decent working conditions to its employed labor. These include: the working hours, health and safety measures, compensation, abstaining from practices of harassment and abuses, child labour and bonded labour practices.¹²³ Similarly Pakistan has ratified all the ILO Core Labour Standards Conventions, relating to the trade union rights, eliminating discrimination against women, prohibiting child labour and abolishing the practices of forced and bonded labour. However it is due to the flagrant violation of these rights that the ILO supervisory bodies are pressurizing government of Pakistan to implement and ensure full compliance with all the ratified laws.¹²⁴

If viewed from the perspective of SMEs in Pakistan, labour right issue does not seem to be a constraint. As most of the SMEs do not comply with state laws, besides this most of the labour employed in SMEs comes under the category of temporary labour or contractual labour and they are the ones whose rights are not properly addressed under the current labour regulations.¹²⁵ However by following this practice they evade the national laws to

¹²¹ HRM means to protect the rights of all stakeholders, specifically of the employed labor within an establishment. Neil Tocher, Mathew W. Rutherford, (2009), Perceived acute human resource management problems in small and medium firms: An empirical examination. Available at <http://www3.interscience.wiley.com/journal/122241988/abstract?CRETRY=1&SRETRY=0> (Accessed May 29 2009), p 457.

¹²² Ibid, pp 445-479.

¹²³ Ralph Luken and Rodney Stares, (2005), Small business responsibility in developing countries: A threat or opportunity? *Journal of Business Strategy and the environment*, Available at <http://www3.interscience.wiley.com/journal/122241988/abstract?CRETRY=1&SRETRY=0> (Accessed May 29, 2009), pp 38-53.

¹²⁴ Internationally Recognized Core Labor Standards in Pakistan, (2008), Report for the WTO General Council Review of Trade Policies of Pakistan, Available at http://www.ituc-csi.org/IMG/pdf/TPR_Pakistan_-_FINAL_11_01_08.pdf (Accessed July 19, 2009), p 1-2.

¹²⁵ For further details see SMEDA Survey 2001. Faisal Bari, et. all, (2005), SME Development in Pakistan, Analyzing the constraints to growth, Pakistan Resident Mission Working paper Series, p 37.

some extent. Currently there exists no effective binding legal framework for SMEs to abide by the labour laws. However the trend of globalization and the CSR movement and trading on international level calls for complying with the core labour standards.

2.2.2 Child labour and bonded labour practices and their adverse commercial impact

Child labour and bonded labour practices prevalent in the industries of developing countries are condemned on international forums. Poverty, lack of educational facilities and economic discrepancies compel the developing countries to employ children in industrial sector. They are hired on minimum wages by the industrial owners. This practice is more common in SMEs as they are considered to operate beyond any system of checks and balances and most of them are not registered according to the corporate laws of the country. However it is a fact that the label of employing child labour and bonded labour always brings a bad repute to the enterprise on international level and its products are often boycotted on this pretext.

The issues of child labour in developing countries became the focus of attention in 1996 when the Federation of International Football Association (FIFA) boycotted the soccer balls of the firms employing child labour. Since then, the issue has been discussed on various international forums, specifically by the International Labor Organization (ILO) and World Trade Organization (WTO), criticizing the Asian and African countries for employing child labour. In the wake of these developments the US and EU declared that for accessing to their markets Core Labour Standards (CLS) have to be followed.¹²⁶ This situation led the developing countries to revise their laws and to follow the CLS as a compulsion. The CLS in

¹²⁶ Farkhanda Mansoor, (2004), The WTO versus the ILO and the case of child labor, Web Journal of Current Legal Issues, Available at <http://webjcli.ncl.ac.uk/2004/issue2/mansoor2.html> (Accessed October 23, 2008), pp 2-3

its ambit includes the four basic internationally recognized rights at work. These rights are the freedom of association, abolition of forced and child labour and elimination of all forms of discriminatory practices regarding employment.¹²⁷

In Pakistan poverty, lack of educational facilities, joblessness and high population are the stimulants for employing children in informal sector and other hazardous work at an early age. Like other developing countries child labour accounts for a substantial proportion of the employed labour in Pakistani SMEs like in cottage industry, leather work, brick kilns and garages.¹²⁸ Globally the issue of child labour was contended against Pakistan in 1996 when the International Labour Rights Fund, pressurized Nike and Adidas, the major soccer balls marketers to boycott soccer balls from the firms not following the FIFA code. As a result of which Sailkot Chamber of Commerce and Industry signed agreements with UNICEF and ILO for eliminating the practice of child labour from their industries.¹²⁹

Bonded labour¹³⁰ practice in the industrial sector of Pakistan is another social issue on the pretext of which its products are often boycotted in the world market. According to the ILO 1993 report worst form of bonded labour exists in Pakistan, particularly in its carpet weaving, brick making, mining and handicrafts industries.¹³¹ The practice of bonded labour

¹²⁷ Although there are a number of labour standards but the CLS are applicable to all the countries due to their international recognition. Core Labour Standards Handbook (2006) ILO, Asian Development Bank, Manila, Philippines. Available at <http://www.adb.org/documents/handbooks/Core-Labor-Standards/default.asp> (Accessed June 21, 2009), p 12.

¹²⁸ M. Aurangzeb, Fayyaz –ur –Rehman, (July, 2005), Child Labor: Social and Economic Issues A case study of Auto Workshop in Peshawar NWFP Pakistan, Journal of law and society Vol, no 46, Law college University of Peshawar, p 2.

¹²⁹ FIFA code of labour practices obliges all the manufacturers using FIFA label to promote freedom of association, eliminate child labour and follow the labour standards. Kimberly Ann Elliot, Richard Barry Freeman (2003), Can labour standards improve under globalization? Published by Peterson institute, p no 114.

¹³⁰ Bonded labour, is an agreement which obliges the person to pay the loan in form of direct labour, rather than in monetary terms. Debt Bondage, Available at http://en.wikipedia.org/wiki/Debt_bondage (Accessed June 1, 2009), p 1.

¹³¹ Farhad Karim, (1995), Contemporary forms of slavery in Pakistan, Human rights watch/Asia. USA. Published by Human rights watch. Available at, <http://books.google.com/> (Accessed May 31, 2009),p 2 .

led to the cancellation of various export contracts of Pakistan¹³², although the state laws completely outlawed bonded labour but still a large number of labour community is involved in it.¹³³ Hence the issue of bonded labour needs to be properly addressed for the flourishing of a vibrant SME sector in Pakistan.

2.2.3 Scarcity of qualified personnel

Lack of skilled and qualified personnel is another human resource constraint on SMEs in Pakistan. The modern industrial units require well qualified, educated personnel and modern technology for their development. Quality human resource is the product of a healthy, highly literate, socially stable and a smooth functioning entrepreneurship culture. An illiterate and unskilled worker cannot give any adequate output. In Pakistan two-fourth of employed labour is illiterate and the rest of one –fourth has only primary education. Most of the SMEs in Pakistan are in need to replace their manual machineries with new technology and managerial skills to enhance their production and quality of products.¹³⁴

In contemporary world Information Technology (IT) plays a decisive role in industrial progress and economic uplift of a country. In Pakistan the ratio of IT education is quite low. Most of the IT institutions in Pakistan are privately owned, charging exorbitant fees from their students, hence hardly afforded by the majority of lower middle class, from where the bulk of labour force comes. Another flaw of these institutions is that their course work

¹³² As in 1995 the “western Pakistani importers, Sweden, Australia, Germany, Belgium and Italy have cancelled its \$10m orders on the pretext of bonded labor”. As international laws completely banes bonded labour practices. Sami Zuberi, Boy, s murder hits Pakistani carpet sales, *The Independent World*, London May 2, 1995, Available at, <http://www.independent.co.uk/news/world>. (Accessd June 1, 2009), p no 1.

¹³³ “The bonded labour was completely outlawed by the bonded labour system (Abolition), Act 1992 and the bonded labour system (Abolition), rules, 1995”. Jatoti Wali Muhammad Danish, (2005), March against bonded labour in Pakistan. *The South Asian*, Sept 18, Available at http://www.thesouthasian.org/archives/2005/march_against_bonded_labor_in.html (Accessed May 31, 2009), pp 1-2.

¹³⁴ Fasih Uddin, M. Akram Swati, (2006), *Pakistan's Economic Journey Need for a New Paradigm*, Institute of policy studies Islamabad, pp 14 -16.

mostly consists of short term certificates courses and diplomas¹³⁵, which hardly produce quality technicians and mechanics for the functioning of modern industrial units. Hence for addressing the human resource issue with reference to SMEs, attention should be paid for increasing the technical education and especially its accessibility to the lower middle income class from where the bulk of SMEs labour comes. By doing so a lot of foreign exchange, which Pakistan currently spends on hiring the services of foreign technicians, can be saved.

2.3 Infrastructural problems

Good infrastructural facilities play a crucial role in the development of SMEs. It's due to the revolution in infrastructure and IT that the world has turned into a global village. The poor economic performance by the developing countries depicts that how infrastructure acts as a constraint on the mobility of goods and products within the domestic and international markets. Infrastructure includes good communication facilities, easy accessibility to the markets, use of E-commerce¹³⁶ in conducting business and availability of technological facilities, physical planning and power supply to the entrepreneurs. The current criteria of trading goods to the foreign and even to the regional markets cannot be fulfilled in the absence of sound infrastructural facilities, as modern day businesses require ISO 9001 certifications and other collateral requirements. Most of the SMEs in Pakistan are encountered by poor infrastructure related problems, primarily lack of technology and frequent breakdown of power supply.

¹³⁵ Faisal Bari, et. al, (2005), SME Development in Pakistan, Analyzing the constraints to growth Pakistan Resident Mission Working paper Series, pp34 -35.

¹³⁶ E-Commerce means using internet in conducting business and as a source of communication with customers and concerned parties.

2.3.1 Shortage of power supply

Modern industries require continuous supply of energy. The importance of power supply to the SMEs can be judged from the current sharp increase in the prices of textile products, especially the cotton cloth in Pakistan. For the last one and half year the whole country is in grip of continuous load shedding, which adversely affected the textile sector of the country. The conventional form of energy in Pakistan is electricity, gas and petroleum. Being a developing country Pakistan is not utilizing the potential of nuclear energy to the extent as is used by the developed countries, as it requires sophisticated high technology. Among the sources of power supply in Pakistan, electricity is the most common mode of power supply to SMEs and its shortage is playing a devastating role in decreasing its manufacturing capacity.

The power supply to SMEs in Pakistan is marked by, high power rates and unreliability, which is a matter of concern for its retailers. The power sector of Pakistan is state controlled. However, it is a fact that the infrastructure of state owned institutions in Pakistan is usually marked with inefficiency. Pakistan was ranked on the top of the World Bank survey conducted 2001, over the power generation and distribution losses in South Asia followed by India and Bangladesh. Similarly line losses, opaque tariff structure and the poorly maintained grid stations are further acting as a constraint on the power sector of Pakistan. Due to the above mentioned facts, the SMEs in Pakistan are compelled to pay huge costs for their power consumption.¹³⁷

The current power crises across the country are damaging the entrepreneurial culture of the country. As most of the SMEs owners are of the view that their industries are at the

¹³⁷ Faisal Bari, et. all, (2005), SME Development in Pakistan, Analyzing the constraints to growth, Pakistan Resident Mission Working paper Series, pp 29- 32.

verge of collapse because eight hours load shedding is making it impossible for such enterprises to carry on their business.¹³⁸ The export oriented SMEs are having the problems of meeting their consignments in time due to continuous power supply breakdowns. The Faisalabad textile sector is an example which is currently incurring loss of billions of dollars due to frequent power shortages.¹³⁹ Though lack of power supply was a factor in retarding the growth of SMEs in Pakistan since its inception but it had never become a stimulant for the closure of SMEs as it is currently. Hence the issue of power supply needs to be urgently addressed in perspective of the SMEs to save this important sector of the country from collapse.

2.3.2 Lack of technology

The use of technology in SMEs affects its production both in quality and quantity. In this globalized world, countries sticking to the old and manual modes of production can hardly progress and trade beyond their borders. Japan, UK and USA are the leading economies of the world because of their strong industrial sector functioning on modern scientific lines.¹⁴⁰ Technology imparts competitiveness to a firm.¹⁴¹ Information and Communication Technology (ICT) helps the SMEs to become globalised as it narrows down the gap between markets, customers and producers.¹⁴² Adaptation of Technological Capability (TC) is a compulsion for the SMEs in the contemporary world because the current market trends

¹³⁸ Usman Cheema, (2009), Power shortage may shut SMEs, The Nation, 4 June, Available at <http://www.nation.com.pk/pakistan-news-newspaper-daily-english-online/Business/20-May-2009/Power-shortage-may-shut-SMEs> (Accessed 10 August), pp 1-2.

¹³⁹ M. Osman Ghani, (2009), Increasing socio-economic costs due to energy shortages, Business and finance review, June 1, Available at <http://jang.com.pk/thenews/nov2008-weekly/busrev-03-11-2008/p3.htm> (Accessed 5 June 2009), pp 1-7.

¹⁴⁰ Shahid Kardar, (1987), Political Economy of Pakistan, Progressive Publishers, Lahore, p 197.

¹⁴¹ Charles W.L.Hill . *Global Bussiness Today*. (2004) 3rd edition. Newyork USA: Mc GrawHill, p 488.

¹⁴² Muray E. Jennex, Don Amoroso, Olacyie Adelakun, (2004), E-commerce Infrastructure Success factors for small companies in developing economies, Electronic Commerce Research. Vol 4, Available at <http://portal.acm.org/citation.cfm?id=990774> (Accessed June 1, 2009), pp 263-286.

obliges its suppliers to comply with new technology, enhanced efficiency and constant upgrading of quality standards.¹⁴³

From technological perspective Pakistan is a weak country. Its industrial sector and entrepreneurs lack the spirit of innovation, induction of new technology and managerial skills. Most of the employed labour force is illiterate accompanied by scarcity of qualified personnel. According to statistics, machinery of most of the SMEs in Pakistan is out dated and the owners are least willing to take risk by implanting new plants. As a result the productivity, quality and services of goods mainly remain poor.¹⁴⁴

For SMEs in Pakistan adaptation of innovation and technological developments are important aspects of keeping its SMEs vibrant. It will enable them to maintain their competitiveness in domestic and regional markets. It is the diversified field of SMEs which can provide excellent innovation opportunities for developing new ideas and skills.¹⁴⁵ Being a developing country it's high time for Pakistan to reorient its policy towards SMEs by raising awareness among the owners to adapt new technology. However, on behalf of the government it is essential to make the availability of new technology on easy terms and concessional rates.

2.4 Regulatory issues

Regulatory issues for SMEs mean the whole legal setup within which it conducts its business.

Regulatory issues usually have profound effect on the functioning of SMEs in the fiscal

¹⁴³ Marjolen. C. J. Caniels, Henry A. Romijn, (2003), SME clusters, Acquisition of technology capabilities and development: concepts, practice and policy lessons, *Journal of Industry, competition and trade*. 3:3, Available at <http://www.springerlink.com/content.pdf> (Accessed June 1, 2009), pp 187-210

¹⁴⁴ Fasih Uddin and M. Akram Swati, (2006), *Pakistan's Economic Journey Need For a New Paradigm*, Pakistan: Institute of policy studies Islamabad, p 16.

¹⁴⁵ Mohammad Shahid Chaudry, (2004), Country paper Pakistan on strategic partnership in promoting technology incubation systems for SMEs, Small and medium enterprise development authority government of Pakistan, pp 5-6.

matters, like affecting its cost of production. It includes the government policy of tax, tariff, subsidies, grant of licensing, the rules of competition on domestic level, the legal and security environment and regulatory measures. The adaptation of a flexible and SME friendly policy by the government in matters of tax and other regulatory procedures helps the SMEs to flourish. While the adaptation of a stagnant and strict policy retards its growth. Pakistani SMEs face a number of regulatory issues, which are making this sector least attractive for the investors and the starting of an SME enterprise as a cumbersome adventure, with a lot of bottle necks to be countered with. These problems are analyzed as follows.

2.4.1 Export regulations

Export of goods brings a lot of foreign exchange and makes the economy strong. Export to foreign countries by the SMEs requires the following of certain rules and regulations. These rules and regulations are promulgated by the government to be followed before export of products. Flexible procedural laws for the acquisition of export licenses and the government incentives stimulate the exporting capacity of SMEs. However if the law in this regard is opaque and cumbersome it retards exports.

Trade facilitation and enhancing export regulation for the developing countries perspective, was a hot debated issue in WTO Doha Trade Round 2006. Trade facilitation includes the removal of all internal and external barriers to the movement of goods abroad. Though the external barriers are determined by international rules but the internal barriers like reduction of transaction costs, reforms in customs regulation and administration policies are within the domain of the developing countries. According to literature review, it can be stated that in developing countries trade facilitation measures are usually encountered by the

burdensome regulatory laws, poor custom regulations and other trade restrictive practices.¹⁴⁶ Exporting goods by the SMEs imparts them competitive advantage along with enhancing their technological standards and financial position.¹⁴⁷ In the developing countries of Asia, unfavorable rules and regulations, lack of government incentives, export promotion assistance programs and high custom duties are the major internal export barriers.¹⁴⁸ Similarly these countries do not give any preference to their SMEs in granting them export related incentives, as are given by the countries like UK to their SMEs.¹⁴⁹

In Pakistan the SMEs are subjected to a number of export regulations like custom duties and sales tax refund procedures which increase their financial costs. The LSI can fulfill these export regulatory measures, as they are having managerial skills but most of the SMEs do not have such knowledge,¹⁵⁰ thus making them to be suppliers of goods to the domestic market. These costs are acting as binding constraints on the SMEs, which due to their weak financial base can least, afford such costs. The enhancement of exporting capacity of SMEs requires the introduction of changes at policy making level by the government. They should be granted incentives so as to make export an attractive venture for SMEs in the long run.

¹⁴⁶ Tomasz Iwanow, colin Kirkpatrick, (2007), Trade facilitation, regulatory quality and export performance. University of Manchester UK, Journal of international development, 19, Available at <http://www.interscience.wiley.com> (Accessed June 7, 2009), pp 735-753.

¹⁴⁷ Mujahid Ali, (2000), Export behavior of small and medium enterprises, PhD thesis, Bahauddin Zakaria university Multan, Pakistan, p 9.

¹⁴⁸ Based on the results of OECD Member economy policy survey, 2006 conducted for analyzing the barriers to export promotion in the Asian countries. Removing barriers to SME access to International markets OECD (2008), Available at <http://www.books.google.com/books> (Accessed 8 June 2008), p 58.

¹⁴⁹ Dave crick, shiv Chaudry, (1997), UK SME awareness, use and perception of selected government export assistance programmes: An investigation into the effect of the ethnicity, Available at <http://www.emeraldinsight.com/Insight/ViewContentServlet?sessionid=2876E7605355CF575D532DD769CE7C4B?Filename=Published/EmeraldFullTextArticle/Pdf/1600060202.pdf> (Accessed August 10, 2009), pp 72-89.

¹⁵⁰ Faisal Bari, et. all, (2005), SME Development in Pakistan, Analyzing the constraints to growth. Pakistan Resident Mission Working paper Series, p 44.

2.4.2 Law and order situation

The growth of entrepreneurship requires sound law and order situation. In most of the developing countries this is an issue, hampering their economic development. Investors lose their confidence to invest and initiate projects in countries prone to political turmoils, lawlessness, sectarian and ethnic violence. Pakistani industry has been severely affected by the lawlessness and unrest tendencies through out the country. But the current wave of terrorism and internal anarchy, especially Pakistan being a close US ally in its war on terrorism, has retarded the overall industrial growth, while halting the functioning of most of the SMEs situated in the sensitive areas of Karachi and NWFP. Currently it's the lack of sound law and order situation, which is casting a worst impact on the flourishing of SMEs. The impact of these lawlessness tendencies on the growth of Pakistani industries is briefly analyzed as follows.

From the historical perspective, ratio of Gross Domestic Investment (GNP) and (GDP) are good indicators of studying the impacts of lawlessness on Pakistan economy. It was the break down of law and order situation in 1960 that brought the GNP from 5.5% to 1.4%. However in 1960s onwards the GNP showed good performance due to sound political situation: it was around 24.5% and its impact was a decrease in unemployment ratio, as most of the labor force was absorbed by the manufacturing sector. Similarly the 1971 war and political rifts again brought the GDP to 4.8%.¹⁵¹ In 2007-08 the GDP was 4.1, while current GDP of Pakistan in 2009 is 2.4%,¹⁵² due to the worsening law and order situation and the military operation in the North West.

¹⁵¹ Azhar Hassan Nadeem, (2007), *Pakistan: The Political Economy of Lawlessness*, Karachi, Pakistan, published by Oxford University Press, pp, 138-143.

¹⁵² *Economic Survey of Pakistan 2009*, p 5.

It was the Afghan war in 1989, which played havoc with the economic stability of Pakistan. The province particularly affected was NWFP, where millions of Afghan refugees migrated bringing drug and Kalashnikov culture with them. They made their own Bara markets in the outskirts of Peshawar, where the smuggled goods were available on cheap rates, thus distorting the fair market competition for the local entrepreneurs.¹⁵³ Besides this the lawlessness made business a costly affair.¹⁵⁴

It was due to the factor of lawlessness that the number of industries in NWFP reduced from 2,254 to 549 after Afghanistan war of 2001. It also affected the availability of finance to SMEs as Banks are reluctant to lend in such scenario. The industries affected were rubber, marble, chemicals, plastic, paper and tobacco.¹⁵⁵ The SMEs situated in NWFP especially in Swat, are the current example for analyzing the impact of lawlessness on their performance. The military operation in Swat and Buner has led to the closing of 300 Marble factories in, Mardan, Risalpur and of the adjacent areas as the mines supplying raw material are closed due to the ongoing military operation in Swat and Buner.¹⁵⁶

By analyzing the impact of lawlessness upon SMEs, it can be stated that in the current scenario lawlessness is the factor threatening the existence of the SMEs. So for addressing the issues of SMEs, first the law and order situation of the country needs to be

¹⁵³ According to a survey conducted on International risk and security in 1995, Pakistan along with Algeria, Burma, Cambodia and Burundi was declared to be risky for investments. Similarly Control Risks and Groups (CRG), a British consultancy organization in its survey also expressed the same view about Pakistan. Azhar Hassan Nadeem, (2007), Pakistan: The Political Economy of Lawlessness, pp, 138-143.

¹⁵⁴ The SMEs in Pakistan have to bear the expenditures of security related issues. Its ratio in NWFP is 4.5% and in Sindh and Punjab it is 1-2% . Developing SME policy in Pakistan. SME issues paper- for deliberation by SME task force-policy planning & strategy department of SMEDA. Available at, <http://www.smeplolicy.net.pk/smeissues/pdf> (Accessed June 7, 2009), p18.

¹⁵⁵ Hasan Mansoor, (2009), Militancy cripples economy in Pakistan north west, The News, 23 May, Available at <http://www.google.com/hostthenews/articles>. (Accessed June 5, 2009), p1.

¹⁵⁶ Amir Shafaat Khan, (2009), Hunderd of factories closed in Malakand, Dawn.Com, Available at <http://www.dawn.com/wps/wcm/connect/dawn-content-library/dawn/news/business/13+hundreds+of+marble+factories+closed+in+malakand-za-05>, (Accessed August 10, 2009), pp1-2.

restored and improved. Only then the economic performance can be improved and a vibrant entrepreneur culture can flourish.

2.4.3 Lack of application of corporate governance rules

Corporate governance is a legal frame work, which imparts organizational and managerial techniques to the SME. Corporate governance elaborates the hierarchical structure of an enterprise, the duties of directors, rights of stakeholders and the auditing rules. It is the following of corporate governance rules that the SMEs, especially of the developing countries can face the contemporary problems of internationalization and CSR movements. Pakistan is an SME oriented country. The current corporate governance set up of Pakistan in its broader perspective addresses the problems of LSI more efficiently than that of the SMEs. Besides this the corporate governance law is still fragmented as some of its provisions are contained in Companies Ordinance 1984, Code of Corporate Governance, Labour laws and environmental laws, consumer protection laws, banking laws, and securities regulations.

The Code of Corporate Governance given by SECP lacks penal provisions and its voluntary nature gives a free hand to the companies whether to follow it or not.¹⁵⁷ Due to the above stated reasons the law relating to SMEs in corporate matters is inefficient. As a result the common practice among the SMEs in Pakistan is to consider themselves free from legal checks. It's due to this fact that SMEs in Pakistan are often indulged in malpractices like violation of labour rights, child labour and lack of compliance of ISO standards. Hence the non-application of corporate governance rules to the SMEs in Pakistan becomes an issue hampering its growth. For addressing the problems of SMEs in Pakistan, reforms should be

¹⁵⁷ Haron H.Hamid andValeria Kozich, (2006), Corporate governance in an emerging market: A perspective on Pakistan, Journal of legal technology risk and management, Vol. 1, no 1, p 26.

introduced in the existing laws by granting them relaxation in certain areas, while abolishing the criteria of applying various labour laws on the basis of number of labour employed within an establishment. Though the SMEDA, SME bank and some other SME related organizations have started working and are performing well but still much needs to be done for addressing the contemporary problems of SMEs.

2.4.4 Distorted market competition and IPR issues

Fair market practices have a significant impact upon the marketing of products by the SMEs. It's the presence of fair market rules that encourages healthy competitive practices among the entrepreneurs. Fair market rules, as a whole include the following of intellectual property rights, abstaining from counterfeiting practices and preventing sale of the smuggled goods on cheaper rates within the local market. The presence of such tendencies in Pakistan is common. However a sharp increase in such tendencies was witnessed after the Afghanistan war, when special markets were established for the sale of such goods like china market in Swat and Bara in Peshawar.¹⁵⁸ This distorts the market competition for the local SMEs.¹⁵⁹ Similarly in Pakistan counterfeiting of local products is a common practice. In such cases the major impediment is the functioning of most of the SMEs outside the legal code of Corporate Governance: hence they can not take adequate action against their adversaries indulged in the counterfeiting practices. This distorts the fair market competition and promotes supply of substandard goods in the market.

¹⁵⁸ Due to the porous borders of Pakistan with Afghanistan and China, a lot of goods are smuggled, which are then sold on cheaper rates, as custom and excise duties are not paid on them. Thus distorting the market competition for the local manufacturers as they have paid the required taxes and excise duties on their products before their marketing.

¹⁵⁹ Legal action against such marketers cannot be taken as such markets are situated in FATA and other Agencies of NWFP. There the Frontier crimes regulations (FCR) are enforced, the laws inherited from the British colonial rule. These only contain a few rules regarding settlements of disputes and local jirga system. While it is the companies law which deals to redress the issues of distorted market competition and IPR issues.

Distorted market competition from smuggled goods and unregistered companies has a profound affect on the sale and marketing of SMEs in the domestic market.¹⁶⁰ This trend is acting as a binding constraint on the growth of SMEs, which are already getting a narrow margin of profits.¹⁶¹ The presence of a strong Intellectual property Rights (IPR) mechanism is important for the developing countries, as it attracts foreign investment and maintains the originality and quality of products by giving copy rights to the original producers.¹⁶² Though IPR rules are meant for promoting fair market competition but in developing countries it usually turns to be a legal corporate issue, where the enforceability of such rights is cumbersome and vague.¹⁶³

The availability of counterfeited goods is on increase in Pakistani local markets, affecting the consumers as it becomes difficult to distinguish between a counterfeited and original brand for a layman. In Pakistan this trend is threatening the lives of people, especially when such counterfeiting is done in medicines and life saving drugs. Hence the issue needs to be addressed properly to protect the rights of all the stake holders involved and for enhancing fair market competition. East Asian economies diverted there attention to this issues after the financial crises of 1998. Now it's the time for Pakistan to curtail this issue for promoting a healthy and vibrant entrepreneur culture and for broadening its industrial base.

¹⁶⁰ Iqbal Mustafa and Farrukh M. Khan, (2005), Small & Medium enterprises in Pakistan, Journal, South Asian. Available at http://www.southasianmedia.net/Magazine/Journal/9-small_Medium_enterprises_pakistan.htm (Accessed June 10, 2009), pp 1-4.

¹⁶¹ Faisal Bari, et. all,(2005), SME Development in Pakistan, Analyzing the constraints to growth. Pakistan Resident Mission Working paper Series, p 48.

¹⁶² Developing SME policy in Pakistan. SME issues paper- for deliberation by SME task force-policy planning & strategy department of SMEDA, Available at <http://www.smeplolicy.net.pk/smeissues/pdf> (Accessed June 7, 2009), p 18.

¹⁶³ World Bank survey of 2002 indicates that the East Asian Economies have enforced the IPR by legal and judicial mechanism, as it promotes fair market competition and strengthens the economy. Faisal Bari, et. all, (2005), SME Development in Pakistan, Analyzing the constraints to growth. Pakistan Resident Mission Working paper Series, p 48.

Chapter 3

Effective legal framework for countering the contemporary problems of SMEs in Pakistan

Introduction

In this chapter the need for an effective legal framework for countering the problems faced by the SMEs in Pakistan is discussed. In Pakistan the SMEs sector is showing excellent performance by contributing to GDP and in combating the rising ratio of unemployment in the country. Currently Pakistani SMEs are facing a number of problems in the legal sphere, which are hampering their performance. The basic purpose of legislation should be to advance better performance and standardize the rules and regulations. In Pakistan there are a number of laws dealing with the SMEs. The basic problem is the lack of an effective implementation strategy. Similarly the current laws grant no relaxation to the SMEs on the basis of their size. An effective legal framework for the SMEs can effectively address their contemporary problems. This can be done by simplifying and promoting the existing rules and regulations for the SMEs. The need of hour is to focus on the implementation strategies which will promote an environment of corporatization for the SMEs.

In Pakistan the SMEs are governed by the Companies Ordinance 1984, various labour laws, the SECP and by the SMEDA. The companies law elaborates the procedure for registration of the company and other essential subsidiary matters relating to the working of the company. The labour law in its ambit secures the rights of employed labour along with obliging the establishments to take into account all the measures for the safety of the labour and to grant them maximum social and financial securities in form of pensions and

compensations. The SECP through its code of corporate governance enacts the listing requirements for the companies on stock exchanges. It obliges the companies to keep a vibrant system of checks and balances for eliminating the chances of corporate frauds. Currently the SMEDA is playing a crucial role for promoting the entrepreneur culture through out the country. Established in 1998 it has done a significant job for the SMEs by compiling all the regulatory laws in a simplified form thus removing the ambiguity regarding the compliance of SMEs relevant laws for SMEs owners. SMEDA successfully launched various projects helping the SMEs financially and technologically. It focused on raising awareness as to how the compliance of national and international standards can enhance the performance of SMEs and bring them maximum benefits.

The contemporary laws related to SMEs in Pakistan are brief and exhaustive. Some of the labour laws are applied only to the establishments employing particular number of labourers. Similarly the voluntary nature and lack of penal provisions makes the SECPs code of corporate governance less effective.¹⁶⁴ Pakistan is a signatory to various ILO and Core Labour Standards conventions but is often blamed for the violation of these laws due to the lack of its effective monitoring mechanism in the SME sector.¹⁶⁵ Similarly the violation of various national and international environmental laws is rampant in Pakistani SME sector.

In the light of above discussion it can be stated that the SMEs in Pakistan need an effective legal corporate governance framework, to tackle its problems. Firstly, to make the existing laws for SMEs simple and standardized. Relaxation should be granted to SMEs in matters of taxation and other regulatory burdens. Microfinance schemes for the SMEs along

¹⁶⁴ Haroon H. Hamid and Valeria Kozich, (2006), Corporate governance in an emerging market: A perspective on Pakistan, *Journal of legal technology risk management*, vol.1 pp 26-27.

¹⁶⁵ Internationally recognized core labor standards in Pakistan (2008) Report for the WTO general council review of trade policies of Pakistan, International trade confederation Geneva, Available at http://www.ituc-csi.org/IMG/pdf/TPR_Pakistan_-_FINAL_11_01_08.pdf (Accessed June 29, 2009), p 2.

with promoting leasing and loans on easy terms are necessary for solving the financial problems of SMEs. Government should ensure good infrastructure facilities as it plays a significant role in providing easy communication and lowers the cost of production. Providing advisory services to the SME sector and raising awareness regarding the potential benefits of compliance of SMEs laws by the government along with active monitoring techniques are effective tools for promoting a healthy entrepreneurial culture in Pakistan. No country in the contemporary world can progress in isolation, hence Pakistan has to strengthen its bilateral trade relations on regional and international level.

This chapter gives a brief critical analysis of the existing corporate governance laws of SMEs, along with highlighting the shortcomings of the existing laws in detail. This chapter focuses on the question that how the current corporate governance laws can be modified to benefit the SMEs by removing the hurdles faced by them. Similarly it gives recommendations for making the contemporary SMEs laws more favorable for encouraging their corporatization.

3.1 Contemporary corporate governance laws of SMEs in Pakistan

Corporate governance laws play an important role in the development of entrepreneurial culture in a country. As they strengthen the role of state regulatory institutions and imparts transparency and minimize the chances of corruption and other manipulative practices within the corporate sector. The major contemporary corporate governance laws in Pakistan enacting rules and regulations for the SMEs can be broadly divided into two categories: the laws governing the regulation of the company; and the laws governing the regulation of activities of the company. The laws relating to the regulation of the company is the Company Ordinance 1984, which specifies the procedure of formation and working

mechanism of a company whether small or large. In regulating activities of the companies, the relation between the company and other stakeholders especially the employed labour is focused. Under this heading come all the labour laws of the Pakistan. From SMEs perspective the contemporary laws implemented through the Securities and Exchange Commission of Pakistan (SECP) and Small and Medium Enterprise Development Authority (SMEDA) also provide a code of conduct for the SMEs to be followed. These laws and their impact upon the SMEs are briefly analyzed as follows.

3.1.1 Regulatory companies' law

Company law regulates the functioning of a company. It provides a set of standardized rules which every company has to follow before and after its incorporation. Incorporation confers legal status to an enterprise, giving rise to certain privileges and liabilities. After incorporation the company becomes liable to stand by the state corporate laws like taxation, holding of meetings, appointment of directors and the publication of financial statements. The Companies Ordinance, 1984 is the main statutory regulatory corporate law of Pakistan applied to all the companies. It lays down briefly the terms and conditions for the registration, working capital, appointment of directors, rights of shareholders, winding up procedure and the auditing rules for the companies. The basic grievance against the Companies Ordinance from the perspective of SMEs in Pakistan is its indiscriminate application to both the LSI and SMEs. It gives no privilege to the SMEs on the basis of their size, due to which most of the SMEs consider the following of the Ordinance as a costly and burdensome affair.

The Companies Ordinance, 1984 exhaustively deals with all the corporate affairs of the company. However from the perspective of legal framework for SMEs the relevant

clauses of the Companies Ordinance, 1984 proving a burden for them, are those dealing with the holding of meetings, maintenance of accounts, auditing procedures and filling of financial reports. These clauses of the Companies Ordinance impose additional regulatory and financial burdens upon the SMEs. This can be hardly afforded by them due to their small size and underdeveloped institutional set up.

Section 157 of the Companies Ordinance, 1984 states that every company holding a statutory meeting should forward a properly certified statutory report to each member 21 days before such meeting containing all the particulars as to the state of affairs of the company. Correspondingly the holding of annual general meeting and extra ordinary meeting also needs a prior notification of 21 days with full particulars to be complied with.¹⁶⁶ Section 230 lays down the rules for full compliance of maintenance of a company's accounts.¹⁶⁷ Similarly section 252 of the Ordinance obliges the company to employ well certified auditors for their enterprises.¹⁶⁸ These laws can be easily followed by the LSI as most of them maintain a separate accounts and auditing section within an enterprise. However, the twenty one days prior notification for the shareholders meeting makes it difficult for the SMEs to take prompt decisions in cases of urgency. Such provisions of the Ordinance with its impartial application to the SMEs and LSI are deterring the SMEs from incorporation under the Companies Ordinance.

For addressing the above mentioned concerns of SMEs in Company Ordinance, 1984, the UK Corporate Law Review Steering Group (CLRSG) report for simplification of the existing company laws for the small scale companies can be taken as a role model, in which they have tried to moderate a few rules of their laws. According to the CLRSG the

¹⁶⁶ Sections 158-159, Companies Ordinance 1984.

¹⁶⁷ Section 230, Companies Ordinance 1984.

¹⁶⁸ Section 252, Companies Ordinance 1984.

minimum period for shareholders meeting should be fourteen days.¹⁶⁹ The CLRSG proposed to shift the reporting and auditing requirements from statutory to standard for the small companies, thus drafting the Financial Reporting Standards for Smaller Entities (FRSSE). Similarly for doing away with the cumbersome procedure of filing reports and accounts, a rule of filing just one set of report and account was proposed.¹⁷⁰ To relieve the small companies from the normal auditing process, the idea of independent professional review (IPR) was envisaged, which is inexpensive and small companies friendly.¹⁷¹ By introducing the above stated provisions the UK small company's legislation became a precedent for countries desiring to promote entrepreneurial culture in their countries.

3.1.2 Labour laws

Labour laws are considered to be the most controversial area of corporate legislation, as human factor is involved in it. There are fifty six labour laws in Pakistan. All of these regulations treat the SMEs and LSI on equal basis, except a few. These abundant rules and regulations, accompanied by frequent labour inspection and official interference by the government functionaries act as an impediment in the functioning of SMEs.¹⁷² Among these numerous laws the laws relevant to the SMEs are those dealing with employer and employees relation. These laws protect the interest of employees in an establishment and are in need to be applied by the SMEs in their legal frame work. These laws include the rights of

¹⁶⁹ Modern Company Law, (2000), For a competitive economy developing the framework, A consultation document from the Company Law Review Steering Group, p 9.

¹⁷⁰ Ibid, pp 19-20.

¹⁷¹ Ibid, p 23.

¹⁷² Shahab Khawaja, (2006), CEO SMEDA, Unleashing the potential of the SME sector with a focus on productivity improvements, Available at, <http://siteresources.worldbank.org/PAKISTANEXTN/Resources/293051-1147261112833/Session-3-2.pdf> (Accessed April 2, 2009), p10.

formation of collective bargaining agents, rights of safety and levies and the rights to obtain fixed wages and benefits of provident funds.

From the perspective of SMEs, labour laws can be divided into three categories. The first regulates the relation of employer with employees; the second category deals with endowment of levies; and the third category obliges the enterprise to comply with minimum working conditions.¹⁷³ The relation between employer and employee is regulated by the Industrial Relation Ordinance (IRO) 2002. The IRO consolidates the law relating to formation of trade unions, gives a comprehensive mechanism for the settlements of disputes between the employer and employees and improves the relationship between the employer and employees. The presence of trade unions and collective bargaining agents within an enterprise keeps a check on the unrestricted powers of the employers in an establishment. The IRO (2002) contains provisions for addressing the individual grievance of the labour through courts.¹⁷⁴ IRO (2002) is recently supplemented by the Industrial Relation Act (2008) which further broadens the scope of application of IRO (2002).¹⁷⁵

Labour law related to levies and compensation for the employees consists of a number of Acts and Ordinances. They are: Employees Old Age Benefit Act 1976, Provincial Employees Social Security Ordinance 1965, Workers Welfare Fund Ordinance 1971, Workers Children (education) Ordinance 1972, Companies Profit (Workers participation) Act 1968 and Workers Compensation Act 1923. These laws legally oblige the employer to

¹⁷³ Labour Laws Compliance (2006), SMEDA, Available at <http://www.smeda.org/downloadinfo.php> (Accessed July 7, 2009), p 3.

¹⁷⁴ Sections 3, 20, 46 Industrial Relation Ordinance 2002.

¹⁷⁵ Industrial Relation Act, (2008), was promulgated to bring the IRO (2002) in full conformity with Article 17 of the constitution of Pakistan, which guarantees the freedom of association and a right to equal protection of law. It narrows down the exceptions to the application of IRO (2002) and enhances the definition of establishment, industrial disputes and collective bargaining agent and other terms used in IRO 2002. Mohammad Abdel Ghani, (2008), Comments on newly promulgated Industrial Relations Act 2008, Available at <http://www.defence.pk/forums/economy-development/11340-comments-newly-promulgated-industrial-relations-act-2008-i.html> (Accessed July 8, 2009), p 1.

take into account all the social provisions for the employed labours within an establishment.¹⁷⁶ These laws may be faultless in their essence, however from SMEs perspective the basic flaw in these laws is their application to sizeable organizations. Similarly most of the SMEs in Pakistan are unregistered and operate beyond the scope of such laws. As a result most of the SMEs employees are deprived of such benefits and privileges.

Labour laws setting standards at work are of significant importance. Insertion of adherence to labour standards in international trade agreements is a current trend. This field of legislation comes under the ambit of national laws of the state.¹⁷⁷ The most common complaints regarding the working standards in the LDC are the unhygienic working conditions, lack of emergency arrangements in times of danger, the use of coercive practices by the employers and late and below minimum wage payment.¹⁷⁸ In Pakistan there are main eight labour laws setting minimum standards required by the employer to be followed. They are: the Shop and Establishment Ordinance 1965, West Pakistan Industrial Relation and Commercial Employment (Standards Orders) Ordinance 1968, the Factory Act 1934, the Employment of Children Act 1991, and the Apprenticeship Ordinance 1962.¹⁷⁹ However, the application of these laws is subjected to a specific number of labours employed hence most of the SMEs evade such laws. These laws need an effective implementation strategy for the SMEs in order to prevent the boycotting of their products on the pretext of violation of labour rights in the world markets.

¹⁷⁶ Labour Laws Compliance (2006), SMEDA, p 6.

¹⁷⁷ Gary Clyde Hubaver, Shahid Javed Burki, (2006), Sustaining Reforms with a US-Pakistan Free Trade Agreement Peterson Institute for International Economics, Available at, <http://books.google.com.pk>, (Accessed July 8, 2009), p148.

¹⁷⁸ Institute of International Economics, (2000), Globalization versus Labour Standards? Available at http://www.pie.com/publications/chapters_preview/338/1ie3322.pdf (Accessed July 8, 2009), p 19.

¹⁷⁹ Labour Laws Compliance, (2006), SMEDA, pp 14-15.

Payment of wages to the employees is an important aspect of labor laws. In Pakistan the laws fixing the minimum standards for wages are dealt by the Payment of Wages Act 1936, the Minimum Wages Ordinance 1961 for unskilled labour and the Minimum Wages for Unskilled Workers Ordinance 1969.¹⁸⁰ These laws make no discrimination on the basis of number of labour employed and are applicable to all establishments. The SMEs should be made to comply with such state laws via an effective implementation strategy, as they advance the interest of the labour employed in an establishment. It is after the complying of SMEs with these laws that they will be able to fulfill the requirements of Core Labour Standards (CLS) and Corporate Social Responsibility (CSR) movement in near future.

3.1.3 Securities regulation Laws

Securities regulation laws are an important area of corporate governance laws. In Pakistan the securities regulations laws are controlled by the Securities Exchange Commission of Pakistan (SECP). The SECP was established in 1999 for the regulation of corporate sector of the country. SECP administers all the corporate laws of the country. Its mission is to promote a fair and well-organized corporate sector, based on sound regulatory principles to help in the economic development of the country. It is an efficient corporate laws regulatory body promoting principles of good governance in the corporate sector of Pakistan.¹⁸¹

By the end of the current financial year 839 new companies were registered with the SECP. Among these 775 were private companies and 26 were single member companies.¹⁸² This figure indicates that this organization is doing a creditable job in

¹⁸⁰ Labour Laws Compliance (2006), SMEDA, pp 13-14.

¹⁸¹ Securities and Exchange Commission of Pakistan, Vision of the SECP, Available at <http://www.secp.gov.pk/SiteOverview.asp> (Accessed July 9, 2009), p 1.

¹⁸² Policy Updates, (2009), CACCI profile, (A compilation of rules, laws and policies on trade and investments in CACCI member countries) Available at

encouraging the corporatization of SMEs. The compliance of SECP laws by the SMEs can solve its various problems, as the status of legal entity confers a lot of advantages upon the corporate entity. The companies registered with the SECP have the advantage to list their shares on the stock exchanges thus providing them the chances of getting more investments. The divisions of SECP more relevant to the SMEs are its Human Resource division and the division dealing with the imposition of taxes.

The Human Resource (HR) and Training division of SECP devises policies for HR development in reference to the employees' benefits and compensation, along with focusing on various employees policies pertaining to promotion, transfers and dismissals.¹⁸³ For SMEs HR factor is an issue and needs to be addressed by taking enforcement actions. Being entrusted with administration of laws SECP should set minimum standards for the SMEs to comply with the HR laws, as they are far behind the LSI in the field of technological advancement and strong institutional and administrative set up.

The SECP has done a commendable job by providing a conducive regulatory environment for the SMEs. SECP is working in close collaboration with the SMEDA for encouraging the corporatization of the SMEs. For this purpose SECP has reduced the amount of fees paid by the promoters for incorporating a company.¹⁸⁴ The SECP took a creditable step by giving tax concession to the SMEs registered under the Companies Ordinance, 1984. Similarly the corporate tax rate on small companies is reduced from 50% to 20%. This reduction was aimed to encourage the conversion of SMEs from non-

<http://www.cacci.org.tw/CACCI%20Profile/2009/Aug2009/PolicyUpdates2009Aug.pdf> (Accessed August 14, 2009), p 1.

¹⁸³ Securities and Exchange Commission of Pakistan, SECP HR & Training division, Available at http://www.secp.gov.pk/divisions/Portal_HrTraining/index_hr_t.asp (Accessed July 9, 2009), pp 1-2.

¹⁸⁴ Securities and Exchange Commission of Pakistan, SECP Facilitation, Available at <http://www.secp.gov.pk/facilitating> (Accessed July 9, 2009), p 1.

corporate entities to the corporate entities.¹⁸⁵ These measures show that the country's top corporate administrative body will help in promotion of entrepreneur culture in Pakistan, while making SMEs more competitive and reliable for investments.

3.1.4 Small and Medium Enterprises Development Authority (SMEDA) and its policies

The Small and Medium Enterprises Development Authority (SMEDA) played a purposeful role in the development of SMEs since its establishment in 1998. Its aim was to help and facilitate the development of a vibrant SME sector in the country. The Vision of SMEDA is: "The growth of globally competitive SME sector through a conducive and facilitating environment and support services as an engine of growth and sustainability to national economy".

SMEDA aims at encouraging the growth of SMEs. For this purpose it has devised various strategies at the government level to counter the problems of SMEs like access to credit, technology along with strengthening the relation of SMEs with various governmental authorities. To address the contemporary challenges SMEDA is arranging workshops, seminars and conducting various training programs to facilitate the SMEs in getting access to the world market.¹⁸⁶

In pursuance of SMEs development the government promulgated the SMEDA Ordinance in 2002. It gives the details of organizational setup along with specifying the powers and authority of the SMEDA. The ordinance in its preamble provides that its

¹⁸⁵ The Task Force on Corporate Tax Policy, Report (2005), Available at http://www.secp.gov.pk/Reports/rpt_TaskForce_CorpTaxPolicy.pdf (Accessed July 9, 2009), pp 19-20.

¹⁸⁶ Small & Medium Enterprises Development Authority, Available at http://www.smeda.org/SMEDA-introduction_1.html (Accessed July 10, 2009), p 1.

purpose is to establish a Small and Medium Enterprise Authority, as an autonomous body under the federal government for encouraging and facilitating the development and growth of small and medium enterprises, SMEDA provides Regulatory Procedures Services to the SMEs and gives a detailed account of relevant laws required to be followed by them.¹⁸⁷ SMEDA helps the SMEs in conducting pre-feasibility studies before the starting of a project along with assisting the running industries to improve their marketing, technical and innovative skills.¹⁸⁸

The SME policy (2007) given by SMEDA and the Ministry of Industries, Production & Special Initiatives (Moip&SI), Government of Pakistan is a mile stone in the history of entrepreneurial development of Pakistan. This policy was an outcome of the participatory approach of various private sector bodies, chambers of commerce and industries, trade associations, public sector institutions and according to the survey of 1000 SMEs in the country.¹⁸⁹ The basic purpose of the SME policy (2007) was to devise a short and medium to long term policy framework along with an effective implementation strategy for the SME sector development. The main four focused areas in this policy were business

¹⁸⁷ SMEDA raises awareness among the SMEs owners that how the following of copyrights laws, trademarks and custom laws and other relevant laws can secure their rights and promotes fair market competition. It gives a detailed description of export, import regulations to be followed by the SMEs. Small & Medium Enterprise Development Authority, Available at <http://www.smeda.org/business-development/regulatory-procedures.html> (Accessed July 10, 2009), pp 1-2.

¹⁸⁸ Small & Medium Enterprise Development Authority, Available at <http://www.smeda.org/business-development> (Accessed July 11, 2009), pp 1-2.

¹⁸⁹ For the formulation of an SME policy government of Pakistan formed a Task Force in 2004. This Task Force consisted government officials and private sector stakeholders. The Task Force aimed to devise a policy for the SMEs, while identifying the major areas of reforms and to focus on the roles of federal, provincial and local governments in SME development. The Task Force organized four Working Committees for deliberating on the business environment, access to finance, access to resources and services and an SME feedback and monitoring strategy. SME Policy, (2007), Available at <http://www.pakistan.gov.pk/ministries/industriesandproduction-ministry/media/SMEPolicyDevelopment.pdf> (Accessed July 1, 2009), pp 7-8.

environment, access to finance, human resource development, better technology and marketing facilities.¹⁹⁰

For imparting uniformity in collecting and reporting SMEs linked data, the SME policy (2007) gave a single definition for SMEs. According to this definition an establishment will be termed as an SME, if it employs up to 250 labourers, its paid up capital is up to 25 million and its annual sales are up to 250 million.¹⁹¹ For implementation of the policy a number of government ministries and organizations were assigned responsibilities.¹⁹² For evaluation and monitoring the performance of the policy the Ministry of Industries, Production and Special Initiatives, Government of Pakistan (Moip&SI) has to submit annually a report on SME Development prepared by SMEDA to the Parliament. To avoid loopholes regarding the implementation of policy a National Committee on Small and Medium Enterprises (NCSMEs) was set up to coordinate the activities of various organizations involved in the devising and implementation of SME policy (2007) and on provincial level Provincial Committees on Small and Medium Enterprises (PCSMEs) were set up for checking the implementation of policy on provincial level.¹⁹³

By taking a general view of the SME policy (2007) it can be stated that it was an excellent endeavor of the SMEDA and Moip&SI to help the flourishing of entrepreneur culture in Pakistan. For the first time a single accepted definition for SMEs was given. This policy was the result of a thriving mutual deliberation of all the concerned authorities

¹⁹⁰ Ibid, p 11.

¹⁹¹ Ibid, p 14.

¹⁹² The responsibility of SME feedback, monitoring and evaluation was assigned to SMEDA. For regulating the business environment for the SMEs, SMEDA, Ministry of Industries and production, Ministry of Justice and Human rights, Trade Associations, Chamber of commerce and industries were held to be responsible. To get access to finance and related services the State Bank of Pakistan, Ministry of Finance, SMEDA and Ministry of Industries and production were to act in collaboration. While access to resource and services was to be dealt by the Higher Education Commission, SMEDA, Technology Up gradation & Skill Development Company, Ministry of finance, Moip & SI and Management of Science and Technology Universities. Ibid, p 22.

¹⁹³ Ibid, pp 23-24.

associated with SMEs development. It contains provisions for the periodical assessment of the policy along with effective implementation framework for the proposed policy. It is hoped that a successful execution of this policy will usher a new era in the flourishing of entrepreneurial culture of Pakistan.

3.2 Flaws in the existing laws related to SMEs

The SMEs legislation in Pakistan became the focus of attention for the last couple of years. The existing structure of SMEs laws is striving to achieve its development at a fast pace. However being a recent field of legislation it is marked by certain loopholes. As most of the policy making in Pakistan was centered on the LSI till 1998, legislation related to SMEs came to the forefront after establishment of SMEDA. This promulgated a number of SMEs specific laws to tackle its diverse problems. Being a new field of legislation the contemporary laws of SMEs in Pakistan still contains a number of flaws like fragmented nature of laws, voluntary compliance, lack of penal provisions, weak legal enforcement mechanism, sized specific laws and the non-compliance of CLS and ILO laws. These issues are briefly analyzed as follows.

3.2.1 Divergent and complicated legal structure for SMEs

An effective and consistent legal set up plays a decisive role in the development of SMEs. It is the presence of clear cut and uniform policies which imparts standardization of procedures and practices for the enterprises. Currently the SMEs in Pakistan have to follow a number of divergent laws. In Pakistan most of the corporate laws are applied both to the SMEs and LSI indiscriminately. This indiscriminate application of laws is deterring the SMEs from formal registration with state authorities. Another reason for this attitude is that most

of the SMEs in Pakistan are owned by sole proprietors; coming mostly from the rural areas hence cannot comprehend such diversified field of corporate laws. Thus most of them prefer to remain unregistered. However this status has its own draw backs, like lack of access to formal modes of financing, technology, access to micro financing schemes and other incentives from government.

Currently the legal provisions related to SMEs falls within the ambit of Companies Ordinance 1984, Labour laws, Securities Regulations and the newly established SMEDA. These overabundant corporate laws are usually fragmented between various entities as the corporate governance laws currently fall within the scope of companies Ordinance and the code of corporate governance given by the SECP.¹⁹⁴ Till the end of the last decade most of the efforts regarding the introduction of reforms in the corporate sector were focused on LSI. Though policies measures were initiated by the various governments for SMEs development but most of them lacked coherence. This trend made the legal environment for SMEs opaque.¹⁹⁵ It was after the creation of SECP and SMEDA when the SMEs were given priority in legislation. The current labour laws of Pakistan are the result of the inconsistent legislation of various governments being promulgated in pursuance of their policies and parties manifestoes.¹⁹⁶ Currently there are 56 labour related laws in Pakistan. The presence of such a diversified field of labour laws make it unfeasible for the SMEs to comply with it.¹⁹⁷

¹⁹⁴ Haroon H. Hamid and Valeria Kozich, (2006), corporate governance in an emerging market; A perspective on Pakistan, p 29.

¹⁹⁵ Shahab Khawaja, (2006), CEO SMEDA, Unleashing the potential of SME sector with a focus on Productivity Improvements, pp 4-6.

¹⁹⁶ By taking a brief review of the history it can be stated that most of the labour laws in Pakistan were promulgated but they were implemented in Bhutto's government, according to his policy of massive Industrialization and Socialist orientation. Pakistan Agenda for Action Interim Report (2008), United States Agency International Development (USAID), Business Climate Legal and Institutional Reform (BIZCLIR) Available at <http://www.usaid.gov/pk/ecgrowth/reports/BCLI.pdf> (Accessed date July 14, 2009), p no 12.

¹⁹⁷ Developing SME policy in Pakistan, SME issues for deliberation by SME task force, Policy Planning & Strategy Department, Available at <http://www.smeda.org.pk> (Accessed June 22, 2009) p 8.

The procedural laws of taxation and registration for the companies generally vary on provincial basis in Pakistan. In order to get access to the formal modes of credit an SME has to meet up the terms of 20 numerous levies and fees rules at Provincial, Local and Federal level, thus such burdensome paper work and complex procedures deter most of the SMEs from formal modes of financing.¹⁹⁸ Another major flaw in Pakistan corporate laws is not the lack of formulation or initiation of policies and legal rules but it is the lack of sound implementation strategies which makes the law ineffective. This lack of sound implementation of regulatory policies retards the performance of state economic institutions and casts a negative impact on the financial market, ownership and control patterns.¹⁹⁹ This diversified field of corporate laws makes it difficult for the SMEs having underdeveloped institutions and mostly functioning in the remote areas to follow them. As a result of it most of the SMEs in Pakistan are deprived of the benefits of corporatization.

3.2.2 Voluntary compliance

In Pakistan voluntary observance of the corporate laws by the SMEs is another weakness of the prevailing system. Among the contemporary corporate governance laws related to SMEs, it is the code of corporate governance²⁰⁰ and the SMEDA policy which are of voluntary nature. The code of corporate governance encourages the corporatization of SMEs but its voluntary nature of compliance gives a free hand to the SMEs owners as to whether it

¹⁹⁸ SME Development for Employment Generation, (2002), Available at <http://www.pakistan.gov.pk/ministries/planning> (Accessed May 14, 2009), p 8.

¹⁹⁹ Effective implementation of laws requires the introduction of Regulatory Impact Analysis (RIA) mechanism. RIA is a policy instrument judging the positive and negative aspects of a policy before its promulgation. Rasul Bakhsh Rais, Asif Saeed, (2005) Regulatory Impact Assessment of SECP's Code of Corporate Governance in Pakistan, CMER Working Paper Series, No 05-39, Available at <http://cmer.lums.edu.pk/cmer/pdf> (Accessed June 22, 2009) p 1.

²⁰⁰ Haroon H. Hamid and Valeria Kozich, (2006), corporate governance in an emerging market; a perspective on Pakistan, p 26.

should be complied with or not.²⁰¹ Similarly the SME policy of 2007 given by SMEDA is a perfect piece of legislation fostering entrepreneur culture in Pakistan. It tried its best to give a loophole proof policy by involving all the concerned diversified stakeholders and covering all the dark areas from each perspective. However the basic shortcoming of this policy is that it is left to the willingness of the owners to follow it or not.

The basic reason of parting with voluntary compliance of the above mentioned laws is that corporate governance is a newly emerged field of legislation and is at its transitional phases in Pakistan. Hence it will take some time to achieve perfection. In addition to this it seems to be the policy of the government not to make the SMEs overburdened with following rules and regulations and to encourage voluntary corporatization rather than to make it an obligation in its initial stages. However for voluntary compliance it is necessary to raise awareness at the grass root level about the significance of these laws to the SMEs. Similarly the government should try to minimize the regulatory costs of such laws for the SMEs.

3.2.3 Weak legal structure and lack of enforcement mechanism

A strong and efficient legal enforcement mechanism plays a significant role in the flourishing of entrepreneurs and in increasing the confidence of people to invest in new ventures. Investor invests in new projects when they are sure that in consequence of any manipulation or violation of their corporate rights they can get an adequate redress through courts. Pakistan corporate legal infrastructure is marked by a number of inadequacies, like lack of enforcement mechanism, lengthy procedures and absence of corporate law courts dealing

²⁰¹ Voluntary nature of the code of corporate governance was one of the reasons behind the delisting of the companies on Karachi Stock Exchange (KSE), after the promulgation of the code of corporate governance in 2002. As in 2001 there were 747 companies listed on the KSE but in 2004 the number of listed companies was reduced to 633. Ibid, pp 26-27.

exclusively with corporate matters regarding enforcement of stakeholders' rights and Intellectual Property issues.

In legal field the SMEs mostly have to tackle with a particular set of issues, like enforcement of contractual rights, contract repudiation and enforcement of labour rights, distorted market competition, dispute resolution, violation of Intellectual Property Rights and Patent rights related issues. In Pakistan there is a perception among the SMEs that access to formal enforcement mechanism is a costly affair. As both the SMEs and LSI are treated on equal footings regarding the costs of contract enforcement or repudiation.²⁰² The frequent violation of Intellectual Property Rights and the slow non-transparent dispute resolution mechanism is a factor discouraging investment in the SMEs. In such scenario it becomes difficult for the SMEs to be a part of Global Supply Chain (GSC).²⁰³

Pakistan is having a diversified field of labour laws. Still the enforcement of such laws is practically insignificant. The industries of the populous provinces of Sindh and Punjab have frequently suspended labour inspections, the only device keeping a check on the compliance of labour laws within an establishment in Pakistan. Complaints filed in Labour Courts and Labour Tribunals normally remain pending for a number of years.²⁰⁴ As Pakistan's legal corporate field is marked by inefficiency and is overburdened. Similarly the High Courts of all the four provinces are in dire need to have a separate judge for handling the corporate affairs for speedy disposals.²⁰⁵

²⁰² Faisal Bari, Ali Cheema, Ehsan-ul-Haq, (2005), SME Development in Pakistan, Analyzing the constraints to growth, Pakistan Resident Mission Working paper Series No.3, Asian Development Bank, p 47.

²⁰³ SME Development for Employment Generation, (2002), Available at <http://www.pakistan.gov.pk/ministries/planning> (Accessed April 4, 2009), pp 5-10.

²⁰⁴ Pakistan Agenda for Action Interim Report (2008), United States Agency International Development (USAID), Business Climate Legal and Institutional Reform (BIZCLIR), p 14.

²⁰⁵ Haroon H. Hamid and Valeria Kozich (2006) corporate governance in an emerging market; a perspective on Pakistan, pp 28-29.

The National Industrial Relations Commission (NIRC) is the administrative body for addressing the cases of unfair labour practices in Pakistan. However such matters are not decided at once and appeals in such cases are to be filed in the Provincial High Courts. There the trail reopens from the start, taking years to be resolved. In Commercial Legal System of Pakistan, injunctions and maintenance of the status-quo are the common reliefs given to the parties, as only a few High Courts judges are cognizant with labour laws and settlement of corporate disputes. Similarly the dispute resolution mechanism is inefficient and slow, which generally instead of resolving disputes usually leads to its prolongation.²⁰⁶ A strong commercial legal system has a direct effect upon the industrialization of a country

From the above mentioned analysis it can be concluded that Pakistan legal corporate sector is in need to focus on the implementation of corporate laws and speedy disposal of issues. Similarly exemplary punishments should be awarded to the parties involved in violation of Intellectual Property Rights and Patent Rights issues. So as to eliminate such practices in future. In the High Courts special judges exclusively dealing with the corporate matters should be appointed to ensure the speedy disposal of Appeals. These measures will restore the confidence of the investors to invest in SMEs and will help in the development of a strong entrepreneur culture in Pakistan.

3.2.4 A critical review of SME Policy 2007

The SME policy given by SMEDA in 2007 was a good effort for addressing various problems of the SMEs. This policy was the result of joint efforts of government ministries, private bodies and all the stakeholders related with the SMEs in Pakistan. This policy directly

²⁰⁶ Pakistan Agenda for Action Interim Report, (2008), United States Agency International Development (USAID), Business Climate Legal and Institutional Reform, p 16.

dealt with main issues faced by the SMEs along with devising policy evaluation and coordination strategies. Though apparently it was a perfect piece of legislation, however it contains certain shortcomings which are analyzed as follows.

The basic aim of SME policy 2007 is to develop a strong and vibrant SME sector, decline the poverty ratio and unemployment rates. However such policies and schemes in Pakistan were also introduced by various political regimes in the past, but they failed to achieve their desired results because of the lack of well defined regulatory frameworks and sound implementation strategies. The introductory part of SME policy 2007 deals with a number of regulatory measures. However, SMEs because of their underdeveloped institutional setup are in need of fewer regulatory burdens and effective policies capable of timely implementation.²⁰⁷ Issues related with SMEs development comes under the domain of a number of governments departments both at federal and provincial levels, while currently SMEDA lacks a proper organizational structure to coordinate with such numerous institutions. Similarly SMEDA is constrained from launching huge projects for SMEs development because of its limited resources financial and manpower resources.²⁰⁸

The four main focused areas of development in SME policy 2007 are Business Environment, Access to Finance, Human Resource Development (HRD), Technology and Marketing upgrading services. However all of these suggestions are having certain lacunas on the basis of which it cannot achieve the desired results. The business development clause of

²⁰⁷ Government of Pakistan introduced various schemes for the alleviation of poverty and reduction of unemployment like, the Youth Investment Scheme, Yellow Cab Scheme and Self Employment Scheme. However these schemes failed to achieve their desired results. The basic reason behind the failure of these schemes was the lack of sound implementation strategies. Similarly the economic reforms introduced by the powerful regimes of Field Marshall Ayub and Z. A Bhutto for the stabilization of the industrialization sector was not successful as the regulatory impact analyses of the proposed policies were not taken into consideration. Shahid Saleem (2008), SMEDA SME Policy paper 2007, A Critical Review (An analytical commentary upon SME policy proposed by SMEDA Pakistan) Available at <http://www.mpra.ub.uni.muenchen.de/pdf> (Accessed July 17, 2009) pp 4-5.

²⁰⁸ SME Policy, (2007), pp 9-10.

the policy does not assign any specific quota for the most underdeveloped areas. Similarly there are no investment related provisions for the huge overseas Pakistani community in their home industry. In access to finance clause no new concrete recommendations for the availability of finance were given apart from reviewing the existing Prudential Regulations. For addressing the HRD and marketing issues the policy gave recommendations for improving the quality of education and managerial skills. But it does not give any explanation regarding the type and level of education and that how that proposed education will bring a positive change in the existing entrepreneur culture of Pakistan.²⁰⁹

The implementations of the proposed recommendations in the SME policy 2007 are subjected to be supported by an SME Act 2006. However the proposed act is still not promulgated and its future seems to be uncertain.²¹⁰ In policy making the implementation is the most difficult stage. In SME policy 2007 of Pakistan 17-18 pages comprises the introduction and scope of the policy while just half page is given for discussing its implementation. Hence the lack of sound implementation strategy is the major flaw of SME policy 2007.²¹¹

The SME policy 2007 is a good omen for the development of entrepreneur culture in Pakistan, as it addresses the whole bulk of issues faced by the Pakistani SMEs elaborately. However the major shortcoming of the policy seems to be the lack of implementation measures. Similarly access to micro financing schemes for the SMEs are not feasible to solve the credit related problems of the SMEs, so it should be given due consideration. However

²⁰⁹ Shahid Saleem (2008), SMEDA SME Policy paper 2007, A Critical Review (An analytical commentary upon SME policy proposed by SMEDA Pakistan), pp 5-7.

²¹⁰ The Indian Parliament realizing the importance of SME sector has promulgated their SME Act 2006. While in Pakistan it is still deliberated for implementation. Pakistan: Future of Proposed SME Act Uncertain, The News, 11 October 2006, Available at <http://BIDNetwork.PakistanFuture.htm> (Accessed July 17, 2009), pp 1-4.

²¹¹ Shahid Saleem, (2008), SMEDA SME Policy paper 2007, A Critical Review (An analytical commentary upon SME policy proposed by SMEDA Pakistan), p 8.

this policy is a high-quality piece of legislation in the history of SMEs in Pakistan. To overcome its shortcomings it will take some time and certain reforms to enable the SMEs to cope with the challenges of globalization.

3.2.5 Exemption of sizeable SMEs from labour laws on the basis of labour employed

The labour laws of Pakistan are mostly applied to the LSI and SMEs indiscriminately. However a few core labour laws are applied only to sizable establishments. This exemption on the basis of number of labour employed gives opportunity to the SMEs employing fewer numbers of employees to evade these laws. The evasion of labour laws in this globalized world is strictly condemned and the goods of companies discarding such laws are often boycotted. For promoting the marketing of the SMEs on regional and international level such labour laws fostering the rights of the workers should be obliged by them.

The compliance with social standards by the entrepreneurs is a contemporary issue. As most of the buyers in world market ask the Least Developed Countries (LDCs) to comply with a code of conduct, which comprises both the international and national laws relating to the maintenance of a healthy and safe environment at the workplaces.²¹² The environment at work place has a direct impact upon the quality and quantity of production within an establishment. Employees not paid adequately and working in unhygienic conditions can hardly give a good output.²¹³ Among the labour laws the ones which are more relevant to the SMEs and justifying no exemption on the basis of labour employed are those dealing with the right of safety, social security, payment of wages and compensation of

²¹² Joint Statement on Pakistan Decent Work Country Programme (DWCP), (2004), Available at <http://www.ilo.org.pk/DWCP%20Document.pdf> (Accessed July 17, 2009), p 21.

²¹³ Pakistan Agenda for Action Interim Report, (2008), United States Agency International Development (USAID), Business Climate Legal and Institutional Reform (BIZCLIR), p 12.

the workers in case of injury. The Employees Social Security Ordinance 1965 (ESSO) stating provisions for financial help of the employees in event of injury, death or sickness apply to establishments employing five or more workers.²¹⁴

Workers Children (education) Ordinance 1972 is applied to establishment employing ten or more workers. The purpose of this ordinance is to provide educational facilities for the children of workers. Companies Profit (Worker's Participation) Act, 1968, applies to establishments employing fifty or more workers.²¹⁵ The fixed payment of wages decreases the conflicts among the employers and employees. The Pakistan Minimum Wages for Unskilled Workers Ordinance 1969 is applicable to establishment employing fifty or more workers. Hence most of the SMEs are exempted from it.

The West Pakistan Industrial & Commercial Orders (Standing Orders) Ordinance 1968, setting important conditions regarding services are applied to establishments employing twenty or more workers. The Factories Act, 1934 is an important labor law of Pakistan. It obliges the company to maintain a healthy environment and to maintain an effective rescue system in case of any accident or emergency. However this law is applied to factories employing ten or more workers.²¹⁶ The SMEs in Pakistan because of their weak financial and institutional setup cannot oblige all the labour laws; however some of the laws directly affecting the health and safety of the workers should be strictly applied to the SMEs. As these are the ones on the basis of which the SMEs in Pakistan are often criticized worldwide.

²¹⁴ Labour Laws Compliance (2006), SMEDA, p 8.

²¹⁵ Ibid, p 11.

²¹⁶ Ibid, pp 16-18.

3.2.6 Non-compliance of Core Labour Standards and International Labour Organization Standards

The ILO is the main international organization entrusted with the promotion of labour rights across the world. The main purpose of ILO is to obtain decent working conditions in an environment of freedom, equality, security and human dignity without any discrimination.²¹⁷ Being a legislative body it gives a number of laws and regulations to be followed by its member states. However the four main basic and important labour rights of the ILO ratified by its 175 member's states are the, Freedom from forced labour, Non-discrimination at work places, Abolition of child labour and Freedom of association and the right to collective bargaining. Currently the LDCs are in a state of dilemma regarding implementation of these rights. As according to them the indiscriminate application of these rights to their industries will cast a negative impact on their competitiveness and will increase their cost of production. However this is not a genuine argument for evading these rights by the LDCs. As in LDCs export oriented industries child labour is uncommon so the compliance of these rights are hardly going to have an impact on their competitiveness in the world market. Similarly the enrollment of children in schools will enhance the productivity of the country in long run.²¹⁸

In the contemporary world Pakistan is often blamed for the violation of Core Labour Rights though it has ratified all the eight core labor standards of ILO. The real problem is regarding the implementation of these rights along with the fact the some of the provisions of the Industrial Relation Act of 2008 are inconsistent with the ILO standards.²¹⁹

²¹⁷ Joint Statement on Pakistan Decent Work Country Programme (DWCP), (2004), p 5.

²¹⁸ Globalization Versus Labor Standards, (2000), Institute of International Economics, Available at <http://www.iie.com/publications/pdf> (Accessed July 19, 2009) pp 8-17.

²¹⁹ Kashif Talib, (2008), One Voice of Workers, Pakistan Worker's Federation (PWF), Available at <http://www.pwf.org.pk/newsletter/newsletters/August%20-%20One%20Voice%20of%20Workers.pdf> (Accessed July, 20, 2009), p 1.

Pakistan is a member of International Trade Union Confederation (ITUC)²²⁰ and its two affiliates advancing the rights of workers in Pakistan are, the All Pakistan Trade Union Congress having 64,000 members and the Pakistan Workers Federation having 880,000 members.²²¹ The Pakistan Workers Federation is continually asking the government to remove the flaws from the existing labour laws, so as to bring it in conformity with the ILO conventions ratified by the government.

Article 17 of Pakistan constitution gives the right of freedom of association to its citizens subjected to some reasonable restrictions. Correspondingly Pakistan has ratified ILO conventions 87 and 98 relating to the rights of freedom of association and the right to organize and collectively bargain. However the IRO 2008 exempts certain classes of workers from invoking these rights. Similarly it gives enormous powers to the government for curtailing the rights of collective bargaining agent within an establishment. The IRO contains no clear provisions for seeking relief against the unfair labour practices. According to it, only one union can serve as a collective bargaining agent within an establishment. All these provisions of IRO restrict the free exercise of right to form trade unions and bargain collectively and are in contravention of ILO conventions. That's why the Committee of Experts on the Application of conventions and Recommendations (CEACR) and ILO has repeatedly asked Pakistan to amend the IRO in conformity with ILO standards granting full rights of collective bargaining to the workers.²²²

²²⁰ The aim of ITUC is promote and secure the rights of workers globally by forging international cooperation among the trade unions and global institutions. Available at <http://www.ituc.csi.org/> (Accessed July 20, 2009), p 1.

²²¹ Internationally Recognized Core Labor Standards in Pakistan, (2008), Report for the WTO General Council Review of Trade Policies of Pakistan, Available at http://www.ituc-csi.org/IMG/pdf/TPR_Pakistan_-_FINAL_11_01_08.pdf (Accessed July 19, 2009), p 2.

²²² The ILO 2008 is not applied to sectors like, police, armed forces, workers employed in printing corporation, fire services, railways, shipyards, oil installations and most importantly in the export processing zones. All these categories of workers do not have the right to form trade unions or to bargain collectively. Internationally

Pakistan has ratified ILO conventions 100 and 111 relating to Equal Remuneration and Discrimination in Employment and Occupation, which prohibits discrimination against women regarding employment and wages. However the CEACR is asking the government of Pakistan to ensure full implementation of these rights. Similarly Pakistan has fully ratified the conventions 138 and 182, dealing with the elimination of child labour. These conventions ban the employment of children in industries less than fourteen years of age. It prohibits employing children in hazardous and dangerous occupations along with regulating their working conditions. Regardless of the government efforts to combat child labour this peril still exists and a large proportion of children in Pakistan are employed in hazardous industries like, leather, deep sea fishing, carpet weaving, brick making and soccer balls.

Pakistan is a signatory to the ILO conventions 29 and 105, aimed at elimination of forced labour in all of its forms and manifestations. Forced labour and bonded labour are common in Pakistan despite of its being outlawed by the national laws of the country.²²³ The CEACR and ILO strongly condemn the current practices of bonded labour and forced labour in Pakistan. To address the above mentioned concerns Pakistan needs the implementation of its comprehensive National Action Plan for combating forced labour. Judiciary and other state institutions at national and federal level should play an effective role and take action against the industries indulged in such practices.²²⁴

The compliance of labour rights casts a positive impact upon the performance of SMEs. As it enlarges the scope of marketing for the SMEs products at regional and international level. In the contemporary world the compliance of Core Labour Standards is a

Recognized Core Labour Standards in Pakistan, (2008), Report for the WTO General Council Review of Trade Policies of Pakistan, pp 3-5.

²²³ In Pakistan the Bonded Labour System (Abolition) Act, 1992 and the Bonded Labour System (Abolition) Rules 1995, completely outlaws bonded labour.

²²⁴ Internationally Recognized Core Labour Standards in Pakistan, (2008), Report for the WTO General Council Review of Trade Policies of Pakistan, pp 11-14.

new parameter for determining the competitiveness of an industry. In Pakistan there is no shortage of labour laws but it is the lack of effective implementation of laws that undermines the performance of SMEs. Hence legislative measures need to be taken against the industries evading such laws.

3.3 Reforming the corporate governance laws for SMEs

Reformation of corporate governance laws is a new legislative development around the globe. For making the SMEs more productive all countries around the world are evaluating and revising their existing SMEs policies for making them more conducive and competitive for entrepreneur development. For achieving this objective commonly a three tier strategy is adopted by the countries. That is to evaluate the current SMEs laws and regulations, to give recommendations and to gradually reduce the administrative burdens along with simplifying the existing regulatory procedures. In the wake of immense importance of the SMEs, EU in 1999 focused on simplification of procedures for their SMEs by simplifying the existing laws, reducing the administrative burdens and by drafting a user friendliness regulatory framework.²²⁵

The corporate governance laws in Pakistan need reforms. Most of Pakistani SMEs operate informally beyond the scope of corporate governance laws. The following of corporate governance laws by such SMEs will make them steady, transparent and more competitive. The following of these laws will automatically solve a number of SMEs problems, with which they are currently confronted. On the other hand there is a perception that the current corporate governance laws in Pakistan act as impediment in the

²²⁵ W.Von Richthofen, (2002), Labour Inspection: A Guide to the Profession, International labor office, Available at <http://www.books.google.com.pk> (Accessed July 21, 2009), p 230.

development of SMEs because it requires a check on internal procedural affairs of the company, costly disclosure requirements and numerous regulatory burdens.²²⁶

It is a fact that corporatization will increase the regulatory and administrative burdens of the SMEs. But this attitude is having its own negative impacts as an unregistered establishment cannot access to the formal modes of financing nor can utilize the benefits of any other government incentives. Hence the need of the hour is to strike a balanced deal by reforming the current corporate governance laws in certain specific areas, so that it should facilitate the flourishing of SMEs rather than becoming a burden. For making the laws more conducive for SMEs the government should simplify the regulatory procedures, similarly they should be granted some relaxation in tax related issues and in accessing to micro financing schemes. However the SMEs should be granted no relaxation where human factor is involved, like their violation of labour rights and environmental laws.

3.3.1 Simplification and Harmonization of process and regulations

The promulgation of simplified and standardized rules and regulations facilitates trade on domestic, regional and international levels. While numerous and complex corporate laws undermine the competitiveness of SMEs on international level, such laws are difficult to be complied with.²²⁷ Poverty alleviation is the main objective of all developing countries. Historically foreign aid, investment in education and industries were the main tools for economic development. However in the contemporary world the policies of economic

²²⁶ Simplification and Promotion of Laws and Procedures For Corporitization of Small & Medium Enterprises, Strategy Report, A study conducted for the Ministry of Industries and Production, Government of Pakistan and Securities and Exchange Commission of Pakistan, Available at http://www.secp.gov.pk/divisions/Portal_CS/PDF/StrategyReport.pdf (Accessed July 5, 2009), pp 1-3.

²²⁷ Enabling SMEs to Enter the International Supply Chain, (2005), Global Facilitation Partnership for Transportation and Trade, The United Nations Trade Facilitation Network, Available at <http://www.gfptt.org/uploadedFiles/ac85ad3f-04d5-409c-a32f-2ea5a3a2a16e.pdf> (Accessed July 21, 2009), pp 1-2.

upliftment are focused on liberalization of regulations and on the reduction of administrative burdens on national and international levels. Thus reducing the taxes, transaction costs, liberalization of investment laws along with focusing on foreign direct investment and promoting export strategies. In this scenario the world community is stressing for the need to bring reforms in the SMEs laws, so as to remove the excessive Red Tapism from them, while enhancing their performance.²²⁸

Red Tapism, excessive amount of paper work and complex government formalities are the common complaints by the SMEs owners in the OECD countries.²²⁹ Realizing the potential of SMEs the OECD has adopted a three tier policy to remove the burdensome red tapism from this sector. It suggests that the governments should help the SMEs in providing them guidance for meeting their administrative regulations. The administrative requirements should be amended so as to make it flexible for the SMEs. Similarly the regulatory impact assessment of such policies should be conducted, so as to make the administrative regulations more feasible for catering the needs of SMEs.

The United States has successfully implemented a comprehensive program through U.S Paperwork Reduction Act (PRA) for reducing the red tapism for their SMEs. The PRA reduces the amount of paper work for the SMEs required by the federal agencies. According to this Act the Office of Management and Budget (OMB) has to evaluate the practical utility of business before implementing any regulatory costs upon it.²³⁰ The promulgation of the Small Business Paperwork Relief Act (SBPRA) 2003 was another piece of legislation by the US government. Along with reducing the paperwork, a Small Business Relief Task Force was

²²⁸ Paul Dragos Aligca, (2007), Reducing barriers to entrepreneurship as an international development strategy: Implementation challenges and structural constraints, *Development Studies*, Vol 1, Ed Prasenjit Maiti, Available at <http://www.books.google.com.pk> (Accessed July 22, 2009), pp 196-197.

²²⁹ From Red Tape to Smart Tape: Administrative Simplification in OECD Countries, (2003), Policy Brief, OECD, Available at <http://www.oecd.org/dataoecd/9/62/2790042.pdf> (Accessed July 22, 2009), p 1.

²³⁰ Ibid, p 4.

constituted under the SBPRA 2003. The aim of the Task Force was to give additional recommendations to the government for making the SBPRA 2003 more conducive to the small businesses.²³¹ Similarly the Small Business Regulatory Enforcement Fairness Act (SBREFA) 1996 helps the SMEs to work in liaison with the federal regulatory agencies. This Act obliges the federal regulatory agencies to publish small business guides which will assist them in getting the required information about the federal laws.²³²

The US promulgated a number of SMEs laws for reducing their regulatory and administrative costs, inspite of the fact that in its economy the LSI plays a dominant role. From this analysis it can be concluded that reducing the administrative costs helps in promoting SMEs. This issue becomes more important from the developing countries perspective like Pakistan where SMEs are the major contributors of the economy due to scarcity of financial resources and lack of technology. Hence it is the duty of the government to amend the existing laws in favor of SMEs for reducing their compliance and regulatory costs. This will act as stimulant for their active corporatization, as most of the Pakistani SMEs are operating informally due to the fear of burdensome and costly regulatory burdens.

3.3.2 Access to actionable information

Access to actionable information increases the confidence of the investors. In industrial establishments a number of stakeholders are involved whose rights are usually at variance. In such circumstances the awareness and timely enforcement of rights of stakeholders through law enforcing agencies plays a decisive role in the flourishing of entrepreneur culture.

²³¹ Small Business Paperwork Relief Act, SBPRA (2003), Office of Management & Budget, Available at http://www.whitehouse.gov/omb/inforeg_infocoll/ (Accessed July 23, 2009), pp 1-4.

²³² Small Business Regulatory Enforcement Act, SBREFA (1996), Available at <http://www.sba.gov/advo/laws/sbrefa.html> (Accessed July 23, 2009), pp 1-2.

Various problems of SMEs like counterfeit practices, distorted market competition, violation of IP issues and other corporate crimes can be countered if the law in this regard is easily accessible and standardized.

SMEs in the developing countries generally face the problem of access to actionable information like, customs regulations, business advisory services and effective dispute resolution strategies. Similarly getting access to such information is a costly and time consuming affair for the SMEs. The access to actionable information is important for the SMEs for becoming a part of global supply chain. It is the duty of the governments to facilitate the SMEs in getting market information on domestic and international level.²³³

Absence of easy accessible actionable information discourages investment on national and international levels. Slow dispute resolution hampers rapid industrialization and discourages the multinational companies to invest in new innovatory projects.²³⁴ The legal corporate sector from SME perspective in Pakistan is marked by delays and lack of clear cut rules for dispute resolutions along with an inefficient and overburdened courts system.²³⁵ In order to help the SMEs to solve their disputes promptly, the government should promote Alternative Dispute Resolution (ADR) measures. Commercial disputes in Pakistan are governed by the Contract Act 1882, through courts marked by a lengthy procedure. The World Bank (2002) also marked the ADR mechanism as a suitable form of commercial dispute resolution for the countries marked with inefficient judiciary.

Judicial efficiency of the commercial courts is important for resolving corporate issues. The developed countries have set specialized commercial courts for speedy disposal of corporate

²³³ Enabling SMEs to Enter the International Supply Chain, (2005), Global Facilitation Partnership for Transportation and Trade, The United Nations Trade Facilitation Network, Available at <http://www.gfptt.org/uploadedFiles/ac85ad3f-04d5-409c-a32f-2ea5a3a2a16e.pdf> (Accessed July 21, 2009) p 2.

²³⁴ SME Development in Pakistan: Issues and Remedies, Available at <http://www.gcu.edu.pk/Publications/VC-SME.pdf> (Accessed July 23, 2009), p 27.

²³⁵ Haroon H. Hamid and Valeria Kozich, (2006), Corporate governance in an emerging market; a perspective on Pakistan, pp 28-29.

issues. As SMEs constitute a sizeable portion of Pakistan industrial sector, so for helping this sector the government should establish specialized SMEs courts. According to World Bank (2002) the countries of Brazil and Hong Kong have successfully introduced judicial reforms by establishing Small Claim Courts. Though Small claim Courts do exist in Pakistan but they follow the ordinary procedures of the civil courts, hence the need of hour is to equip these courts to help in speedy disposal of issues along with implementation strategies.²³⁶

3.3.3 Relaxation of taxation for the SMEs

Customs and taxes are the sources of revenue for a country. However they are deemed to be a burden if imposed indiscriminately on all the industrial sectors of a country, without taking their scale of sophistication into account. The LSI being functioning on a larger scale and financed by formal means can pay such regulatory taxes and custom duties on their products. But the SMEs because of their underdeveloped setup can hardly afford to pay exorbitant taxes and other regulatory duties. Hence to evade these regulations most of them are forced to operate informally, which has its own negative consequences. To help the SMEs to be out of this dilemma the government should grant some tax relaxation and simplify the taxation laws for these industries.

Reduction of tax compliance burdens through reforms, tax exemptions and by devising simple tax compliance procedures for the SMEs are the devices used by the governments for helping SMEs. A number of OECD countries have introduced reforms for reducing tax burdens on their SMEs. According to the OECD questionnaire 2007 it was suggested that the member's countries should simplify the tax compliance laws by allowing

²³⁶ Faisal Bari, Ali Cheema, Ehsan-ul-Haq, (2005), SME Development in Pakistan, Analyzing the constraints to growth, Pakistan Resident Mission Working paper Series, pp 63-65.

the filling of simplified accounts and tax calculations along with the less frequent filling of tax returns by the SMEs.²³⁷ Under its reform package France grants tax exemption and more favorable terms of tax payment to its SMEs. Likewise Italy has also introduced a tax reform package for its SMEs.²³⁸ The United States excludes the shareholders in SMEs from taxes and other capital deductions.²³⁹ Hence it can be stated that the developing countries have to introduce tax reforms for the SMEs to encourage their tax compliance and corporatization.

For encouraging the SMEs the government of Pakistan has to reevaluate its tax policy. As the current tax structure provides no incentive for the SMEs. However this is a complicated issue and needs critical evaluation from each perspective. Similarly all the concerned stakeholders should be consulted before introducing such reforms, as giving relaxation in such matters will have impact upon the revenue of the country.²⁴⁰ Some areas of taxation reforms for the SMEs in Pakistan are to reduce the current rates of taxes on them. The salaries of SMEs members should not be taxed and procedure for filling the tax returns should be simplified for the SMEs.²⁴¹ The SMEs in their starting stages should be exempted from payment of taxes. These steps will encourage the active corporatization of the SMEs in Pakistan. As high and exorbitant taxation rate is a factor discouraging entrepreneur growth in Pakistan.

3.3.4 Promoting micro financing schemes for the SMEs

²³⁷ SME Tax Compliance and Simplification, OECD, Working Group on Taxation of the SEE Investment Committee, Available at <http://www.oecd.org/dataoecd/22/24/41873897.pdf> (Accessed July 21, 2009), p 1.

²³⁸ OECD SME and Entrepreneurship Outlook, (2005), Edition, By OECD Organization of Economic Cooperation and Development, Available at <http://www.books.google.com.pk> (Accessed July 24, 2009), p 56.

²³⁹ The SME Financing Gap: Theory and Evidence, (2006), Vol, 1, By OECD, Available at <http://www.books.google.com.pk> (Accessed July 24, 2009), p 79.

²⁴⁰ Osama Siddique, (2003), Simplification and Promotion of Laws and Procedures for the Corporitization of SMEs, Review of the Legal and Regulatory Framework for Corporitization of SMEs, Available at <http://www.secp.gov.pk/> (Accessed July 20, 2009), pp19-20.

²⁴¹ Ibid, p 64.

Availability of finance on easy terms has a profound effect on the growth of SMEs. Finance is the major constraint hampering the growth of SMEs in the developing countries. Access to formal modes of finance can cater the needs of SMEs. If the procedure for getting finance from formal institution is SME friendly it can ensure the flourishing of this sector at a fast pace. However due to their underdeveloped institutional set up the SMEs are restrained to borrow from the majority of private lending institutions like banks. Therefore the governments of developing countries should introduced schemes specifically for financing the SMEs, as they play a crucial role in their economic development.

Micro financing²⁴² schemes for alleviating poverty from the developing countries have shown excellent performance in various countries. The Grameen Bank of Bangladesh is a model of successful micro financing scheme for other developing countries. This pattern of financing is now followed by 58 countries around the world, including the developed countries of Canada, US and France.²⁴³ In Pakistan microfinance caters to the needs of only 2% of the poor, while in Bangladesh this rate has grown to 35%.²⁴⁴ Though a number of micro finance schemes are working in Pakistan but the basic flaw of these schemes is the lack of a strong and effective financial institutional foundations. Moreover they are usually

²⁴² Micro finance schemes extend loans to the poor people for starting a business on small scale to generate income.

²⁴³ The Grameen Bank was initially a research project started by Dr Muhammad Yunus in 1979 in Bangladesh. The basic purpose of this project was to extend loans to the poor people to start up business on small scale. This Bank opened its branches in the remote rural districts of Bangladesh. In 1997 the Bank was having 2.3 million memberships, majority of them were the poor and females. Currently the Bank is having 1,084 branches with a high recovery rate. Due to the successful performance of Grameen Bank Dr Muhammad Yunus was awarded a Noble Peace Prize in 2006. The Pakistan Accountant (2007), Issue 4, Available at <http://www.icap.org.pk/userfiles/file/PAsd2007.pdf> (Accessed July 7, 2009), pp 6-7.

²⁴⁴ Tatiana Nenova Cecile Naing, Anjum Ahmed, (2009), Bringing finance to Pakistan Poor, A study on access to fiancé for the underserved and small enterprises. Available at <http://siteresources.worldbank.org/INTFR/Resources/Paper-NenovaNiangandAhmad.pdf> (Accessed July 12, 2009), p 1.

devised without taking into account the needs of their clients.²⁴⁵ Thus most of schemes fail to achieve the required results.

Successful micro financing in Pakistan requires effective strategies and awareness along with sound implementation of policies. The ways and procedures for accessing to the loans of these institutions should be standardized besides introducing reforms to improve the access of women to such schemes at institutional level.²⁴⁶ The SMEs in Pakistan are in need of finance and availability of finance through micro finance schemes can effectively solve the financial problem of SMEs. However for this the government has to strengthen the existing institutions of micro financing along with devising new schemes on the Grameen Bank model.

3.3.5 Improvement of infrastructure and promoting cluster approach

The development of an efficient and modernized infrastructure has a significant impact on the performance of the SMEs. Quick means of communication, access to timely information and linkages with regional and international companies help in the internationalization of SMEs. Good networking facilities help the SMEs to have access to a diverse group of consumers and producers thus helping them to be the participants in the global supply chain. Another factor enhancing the overall performance of SMEs is their working in form of clusters. The working of SMEs in a geographical proximity in forms of clusters gives them competitive advantage and an additional bargaining power in getting tax concessions

²⁴⁵ CGAP Aid Effectiveness Initiative, (2007), A Country Level Effectiveness and Accountability Review with a Policy Diagnostic Pakistan, Available at http://www.cgap.org/gm/document/clear_Pakistan.pdf (Accessed July 12, 2009) p 2.

²⁴⁶ Tatiana Nenova Cecile Naing, Anjum Ahmed, (2009), Bringing finance to Pakistan Poor, A study on access to finance for the underserved and small enterprises, pp 1-2.

and custom duties from the government.²⁴⁷ Working of SMEs in clusters is a stimulant for attracting foreign direct investment by the developing countries.²⁴⁸

The promotion of cluster concept is one of the objectives of United Nations Industrial Development Organization (UNIDO) for SMEs development. According to UNIDO mutual interaction among the SMEs and their networking with LSI will help them in meeting the challenges of foreign markets.²⁴⁹ The UNIDO launched seven projects in Pakistan fostering cluster approach. The Lahore Garments Consortium (LGC) is an illustration of such network, established in 2002, consisting of eight medium sized enterprises. The LGC worked successfully under the supervision of the UNIDO and gave excellent performance. The LGC effectively countered the common problems faced by them, through collective bargaining and by benchmarking their business and HR practices. Similarly it helped them in enhancing their productivity along with diversifying from EU and USA markets.²⁵⁰

Improved infrastructure and adopting cluster approach can improve the overall performance of SMEs in Pakistan at a faster pace. Efficient infrastructure facilitates communication and helps the SMEs to meet the challenges of ISO certification and environmental standards. Similarly working in clusters gives the SMEs a chance to work in

²⁴⁷ Enabling SMEs to Enter the International Supply Chain, (2005), Global Facilitation Partnership for Transportation and Trade, The United Nations Trade Facilitation Network, pp 3-4.

²⁴⁸ United Nations Conference on Trade and Development, (2005), Improving the productivity of SMEs through enhancing productive capacity, Available at http://www.unctad.org/en/docs/c2isard38_en.pdf (Accessed July 21, 2009), p 10.

²⁴⁹ Productivity enhancement and equitable development: Challenges for SMEs development, (2006), Combating Marginalization and Poverty through Industrial Development, COMPID, A UNIDO research program, Available at http://www.unido.org/fileadmin/import/59571_01COMPID_0586128.pdf (Accessed July 24, 2009), p 16.

²⁵⁰ Anjum Fayyaz, Jamshed H. Khan, Sarfraz A. Main, (2008), The impact of formal SME network in emerging economies: A study of formal manufacturing networks in Pakistan, Int. Journal of Technology Intelligence and Planning, Vol.4. No 1, Available at <http://inderscience.metapress.com/app/home/contribution.asp?referrer=parent&backto=issue,8,8;journal,7,19;linkingpublicationresults,1:112381,1> (Accessed July 26, 2009), pp 117-118.

mutual collaboration in adopting new innovative practices and in meeting the challenges of globalization.

3.3.6 Implementation of International Quality Standards and Core Labour Standards

Globalization and Internationalization have set new parameters for trading goods to the world markets. It is the compliance of national and international laws, which determines the competitive advantage of the SMEs in the contemporary world. This issue becomes very important from SMEs perspective because of their underdeveloped institutional set up, lack of awareness and operating beyond the scope of legal authorities. They are indulged in the practice of evading such laws. At present the SMEs in Pakistan are not having the shortage of laws but it's the lack of implementation of these laws to the informal sector. Thus acting as an obstacle in their internationalization and trading of their products on the regional level.

Similarly the SMEs in South Asia usually face the problem of compliance of international quality standards. Due to the lack of compliance these countries are usually restrained from trading their products in the world markets by agencies like WTO, Technical Barriers to Trade (TBT) and on their violation of Sanitary and Phytosanitary Measures (SPS). Moreover there exists a gap between the national environmental laws and international standards in these countries. Thus to enhance their competitiveness, SMEs are in dire need to be supported by the governments and international donor agencies in complying with such standards. They should be helped in getting access to water treatment and toxic industrial waste treatment plants. Because compliance with environmental standards requires new technology and costly treatment plants, which the SMEs can hardly afford. However

the compliance with labour standards is not costly but only requires active vigilance and monitoring on part of the government authorities.²⁵¹

For countering the practice of boycotting of Pakistani goods in the world markets the Core Labour Standards (CLS) and other international standards quality standards needs to implemented on the SMEs. As Pakistan has ratified all the CLS conventions²⁵² along with a strong commitment to comply with all voluntary international environmental laws.²⁵³ Being an active member of ILO Pakistan should show its commitment for the compliance of all the ratified CLS laws. Similarly the national laws should be amended to bring it in conformity with ILO standards regarding the right of forming trade unions and collective bargaining. New effective measures should be taken to end the discrimination against women and to root out child and bonded labour practices completely from the industrial sector of Pakistan. For this purpose Pakistan government should work in close collaboration with the ILO and WTO on legislative and implementation programs and submit its progress reports to WTO trade policy review.²⁵⁴

3.3.7 Linking SMEs with Global Supply Chain through Transnational Corporations

The direct trading of SMEs products to the world market is difficult as they cannot fulfill the international standards unless they have achieved complete technological perfection. In this

²⁵¹ Shaheen Rafi Khan, (2003), Developing Country Initiatives in Complying with International Environmental Standards-Pakistan's Small and Medium Enterprises, SDPI Research & News Bulletin, Vol 10, No.3, Available at http://www.sdpi.org/help/research_and_news_bulletin/may_june_bulletin/articles/pdf/May-June-03.pdf (Accessed July 4, 2009), pp 1-9.

²⁵² Internationally Recognized Core Labor Standards in Pakistan, (2008), Report for the WTO General Council Review of Trade Policies of Pakistan, Available at http://www.ituc-csi.org/IMG/pdf/TPR_Pakistan_-_FINAL_11_01_08.pdf (Accessed July 19, 2009), p 1.

²⁵³ Industrial Policy and the Environment in Pakistan, (2000), United Nations Industrial Development Organization, Available at <http://www.unido.org/fileadmin/import/userfiles/timminsk/rio10-ind-pakistan-eng.pdf> (Accessed July 17, 2009), p 9.

²⁵⁴ Internationally Recognized Core Labor Standards in Pakistan, (2008), Report for the WTO General Council Review of Trade Policies of Pakistan, pp 15-16.

scenario the linking of SMEs with Global Supply Chain (GSC) via Transnational Corporations (TNC) seems to be a feasible option.²⁵⁵ TNC is a corporation that manages manufacturing on new technological lines and delivers services in more than one country.²⁵⁶ Production of goods with the assistance of TNCs by the SMEs is a contemporary trend. TNC helps in transforming SMEs to become global players. As it enhances the competitiveness of SMEs by providing them technology, organizational skills, assist them in specialized goods production and provides best managerial practices. However the major criticism against the TNCs working in the developing country is that it distorts the market competition for the other domestic producers, by providing new innovative modes of production.²⁵⁷ However for tackling this issue the government policies of the developing countries play an important role. The government should forge linkages with those TNCs dealing with new and innovative modes of industrial production for its overall economic development, rather than in petty items like cosmetics, foods and beverages.

The TNCs is a source of Foreign Direct Investment (FDI) in the developing countries. As currently most of FDI from the developed countries comes through TNCs by investing in those local enterprises which are better developed and competitive. The important factor for utilizing FDI is the presence of a competitive SME sector in the recipient country having the willingness to adopt good manufacturing practices from the host country.²⁵⁸ There are a number of patterns for forging linkages with TNCs. From SMEs perspective the best linkage is technological linkage, through which SMEs can upgrade their

²⁵⁵ Enabling SMEs to Enter the International Supply Chain, (2005), Global Facilitation Partnership for Transportation and Trade, The United Nations Trade Facilitation Network, p 3.

²⁵⁶ Available at http://en.wikipedia.org/wiki/Multinational_corporation (Accessed July 29, 2009), p 1.

²⁵⁷ United Nations Conference on Trade and Development, (2005), Improving the productivity of SMEs through enhancing productive capacity, pp 25-27.

²⁵⁸ On Asian level the countries successfully utilizing the FDI via TNCs are Malaysia, Philippines, Singapore and Thailand. The relationship between competition, competitiveness and development, (2002), Issue note prepared by the UNCTAD secretariat, Available at <http://www.sela.org/db/ricsela/edocs/pdf> (Accessed July 22, 2009), pp 13-14.

production from technological perspective and produce specialized goods. TNC provides partnership opportunities for the SMEs with the foreign firms.²⁵⁹

In successful operation of SME-TNC linkage the government, private sector and the international community plays a decisive role. The TNC needs the existence of a sound legal regulatory framework, good infrastructure and trained educated labour force. So it's the duty of the government to ensure the availability of such environment along with devising comprehensive policies to support such initiatives. The business community facilitates and promotes the development of SME-TNC linkages. The business community has to formulate comprehensive policies and feasibilities for networking with TNCs. Keeping in view the importance of SMEs for the developing countries it's the duty of world community to promote dialogue between the developing and developed countries over SME-TNC linkages. Similarly efforts should be made to eliminate the barriers of discriminatory rules of competition against SMEs internationally.²⁶⁰

TNCs are a mode of linking the local SMEs with GSC. It's high time that the government of Pakistan should realize its responsibility to facilitate the collaboration of its SMEs with TNCs. To achieve this purpose the government, state institutions and the SMEs sector have to play their role. The government should provide infrastructure and raise awareness about the prospects of such ventures among the SMEs. The SMEs should try to comply with national and international corporate governance laws and maintain good Human Rights practices for becoming partners with TNCs in the global supply chain.

²⁵⁹ United Nations Conference on Trade and Development, (2005), *Improving the productivity of SMEs through enhancing productive capacity*, p 28.

²⁶⁰ *Ibid*, pp 38-40.

3.3.8 Promotion of Foreign Direct Investment for SMEs

Trading across the borders and getting finance through Foreign Direct Investment has tremendously increased among the developing countries since the last three decades.²⁶¹ FDI is a technique by which the developing countries can counter financial and access to technology related problem faced by their industrial sector. FDI makes the local firms competitive in getting access to the world market.²⁶² However its success depends upon the efforts of the recipient country as to how efficiently they utilize the available opportunity. In contemporary world FDI is a major form of capital flow to the developing countries. FDI helps in adjusting the account deficit of the developing countries. The account deficit of Pakistan, Turkey and South Africa were mainly adjusted by the FDI in 2007.²⁶³

From SMEs perspective it is the investment in technology related ventures that can bring the best out put of the FDI for the developing countries. Investment in Research and Development (R&D) through FDI upgrades the existing modes of production and gives an insight for new innovative practices for the SMEs. However for achieving this purpose various impediments from direct financing to SMEs should be removed. This includes the consideration of SMEs as high risk consumers, with poor corporate governance practices leading to corporate frauds. Similarly lending to SMEs is not considered to be a profitable option. Currently the developing countries are making their policies more conducive for SMEs. For this purpose they have decreased the costs of lending to SMEs along with

²⁶¹ Global Economic Prospects and The Developing Countries, (2003), Investing to unlock global opportunities, World Bank, Available at, <http://www.books.google.com.pk>, (Accessed July 29, 2009), pp 45-46.

²⁶² The Relationship between Competitiveness and Development, (2009), Issue note prepared by the UNCTAD secretariat, United Nations, Available at http://www.unctad.org/sections/ditc_ccpb/docs/ditc_ccpb0020_en.pdf (Accessed July 21, 2009), p 13.

²⁶³ Andrew Mold, (2008), The Fallout from the Financial Crises (4): Implications for FDI to the Developing Countries, Policy Insights, No. 86, OECD Development Center, Available at <http://www.oecd.org/dataoecd/pdf> (Accessed July 29, 2009), pp 1-2.

devising new policies to encourage competition among their Banking Sector regarding investments in the SMEs.²⁶⁴

FDI has provided a new impetus for developing the economies of the developing countries. FDI can play a significant role in economic development of Pakistan, by bringing the much needed finance for investment and modern technology. Similarly FDI stimulates exports as they have better linkages with global networks and also enhances the production by bringing better expertise and managerial skills. For utilizing the benefits of FDI the presence of a dynamic entrepreneur culture is essential, which maintains the confidence of investors in investing in the SMEs.²⁶⁵ For promoting FDI in Pakistan government should reform its policies for regaining the confidence of investors. The first step in this regard is to remove the state of lawlessness from the country and decrease the cost of business. The current energy crises are causing a bad impact on industrial development. Similarly awareness should be raised among the SMEs to comply with the corporate governance laws so as to make them attractive for foreign direct investment.

3.3.9 Helping SMEs to comply with environmental standards

In contemporary world sustainable development cannot be achieved without taking into account the environmental standards. Now there is a trend to harmonize these standards, which means their indiscriminate application to the developed and developing countries. This harmonization of environmental standards is a threat to the developing countries as they lack the institutional, technical and financial resources for complying with them. The

²⁶⁴ United Nations Conference on Trade and Development, (2005), Improving the productivity of SMEs through enhancing productive capacity, p 65.

²⁶⁵ Madiha Mujahid, (2009), FDI has the potential to contribute to Pakistan long term economic development, The News International, Available at <http://jang.com.pk/thenews/may2009-weekly/nos-31-05-2009/pol1.htm> (Accessed July 29, 2009), p 5-6.

most vulnerable sector to these standards is the SMEs of the developing countries who can hardly meet such regulatory standards because of their weak and underdeveloped institutional setup.²⁶⁶

The indiscriminate application of environmental standards and regulations are putting additional burdens on the exports of the developing countries.²⁶⁷ From SME perspective in Pakistan the effect of these international environmental standards can be best understood by taking the textile industry as an example. The textile sector is an important export industry accounting around 60% of export earnings for Pakistan.²⁶⁸ The following of the Eco-label is an example of Non-Tariff Barrier imposed by the developed countries on this sector. Eco-label is a quality label designating that the product is manufactured through an environmental friendly procedure along with complying the ecological criteria set by the European Commission. However this standard has to be strictly followed throughout all the manufacturing stages of fabric like weaving, spinning, processing and stitching. Similarly the International Standards Organization (ISO) gave various standards like ISO 14000, ISO 1400 and ISO 900 elaborating the compliance of environmental standards from various perspectives. The LSI can follow these ISO standards as they have the technical know how, managerial and financial resources to follow it, but for SMEs it becomes a challenge and an obstacle in trading beyond the borders.²⁶⁹

²⁶⁶ Shaheen Rafi Khan, (2003), Developing Country Initiatives in Complying with International Environmental Standards-Pakistan's Small and Medium Enterprises, pp 2-3.

²⁶⁷ In 1996 USA banned imports of Shrimps from countries, engaged in fishing of Shrimps without taking precautionary measures for the safety of Sea Turtles, under its Endangered Species Act. This measure was having a drastic affect on the fisher community of the developing countries. Atif S. Malik, (2002), Impact of Environmental Regulations on the Textile Sector of Pakistan, Country Paper prepared for Expert Meeting on Environmental Requirements and International Trade Geneva, Available at http://www.unctad.org/trade_env/test1/meetings/envreq/paper%20WTO-geneva-tex.pdf (Accessed July 30, 2009), p 14.

²⁶⁸ Ibid, p 3.

²⁶⁹ Putting Eco-label on garments means that during manufacturing of the fabric the manufacturing unit reduced water and air pollution. During manufacturing no toxic and Non-Biodegradable substances were used.

Though following of these standards are of voluntary nature but it affects the choice of consumers and gives competitive advantages to the companies in the world market. In this scenario all the developing countries are trying to adopt cleaner and environmental friendly modes of production, especially for their exporting sector. The first legislative measure in Pakistan for tackling the environmental issue was Pakistan Environmental Protection Ordinance 1983 (PEPO). The major flaw of this ordinance was that it did not contain any adequate provisions for assisting the companies to adopt environmental friendly strategies. Pakistan Environmental Protection Act 1997 (PEP-ACT) was promulgated for strengthening the national and provincial institutions for the execution of environmental policies. Similarly Pakistan National Conservation Strategy (NCS) and the Environmental Planning and Resource Conservation Project (EPRCP) aimed to protect the environment. However these policies cannot achieve their desired results, due to political instability, inefficiency of state institutions, fiscal constraints, lack of awareness and due to the lack of interest of the industrial staff over this issue.²⁷⁰

For addressing the challenges of environmental laws the government of Pakistan has taken various measures for upgrading the institutional and regulatory structure for the effective implementation of such policies. However the current focus of such policies is mainly the LSI, thus causing a negative impact upon the exporting capability of the SMEs to the world market.²⁷¹ For making the environmental policies more effective the government should strengthen the National and Provincial Environment Protection Agencies (EPAS). An effective system for monitoring and assisting the small sector over pollution matters

Along with a guarantee of shrink and color resistance of the fabric and that the required standards were followed throughout all the stages of manufacturing. Ibid, pp 9-14.

²⁷⁰ Industrial Policy and the environment in Pakistan (2003), United Nations Development Organization, UNIDO, Available at <http://www.unido.org.pdf>, (Accessed July 30, 2009) pp 8-9.

²⁷¹ Atif Malik, (2002), Impact of Environmental Regulations on the Textile Sector of Pakistan, Country Paper prepared for Expert Meeting on Environmental Requirements and International Trade Geneva, pp 14-15.

should be devised. Training programs and workshops for raising awareness among the SMEs owners on environmental issues should be arranged. The government should encourage the SMEs to comply with the ISO standards. It's high time for Pakistan to bring its national environmental policies in conformity with international environmental standards as the international buyers are becoming sensitive towards the compliance of environmental policies.²⁷²

3.3.10 Combating the current state of lawlessness and distorted market competition

The flourishing of entrepreneur culture and promotion of FDI requires a stable state and peaceful environment. Anarchy and lawlessness casts the worst impact upon the economic development of a country. The industrial growth is halted and the investors loose their confidence to invest in such countries. Hence for addressing the causes of industrial stagnancy in Pakistan from SMEs perspective the law and order situation needs to be addressed. When the state legislative enforcing institutions are inefficient, it distorts fair competition and gives rise to numerous market manipulative practices, like violation of IP rights, distorted market competition and corporate frauds in the industrial sector. These trends act as an impediment in the promotion of entrepreneur culture in the developing countries.

The major threats to the development of entrepreneur culture in the developing countries are the absence of a fair competition policy, violation of Intellectual Property Rights and lawlessness. According to United Nations Conference on Trade and Development (UNCTAD) Fair and sound competition policies in the market place ensures

²⁷² Industrial Policy and the environment in Pakistan (2003), United Nations Development Organization, UNIDO, p 10.

substantial economic growth in the developing countries. The competition policy has two main objectives; in the first place it eliminates anti-competitive practices from the market. The second objective of competition policy is to promote industrial policy advocating consumer protection standards, Intellectual property Rights and international trade investment and licensing.²⁷³

Violation of Intellectual Property Rights (IPR), the practice of counterfeiting and piracy of goods shake the confidence of investors to invest in the developing countries.²⁷⁴ IPR gives exclusive right of production and selling of a product to its original manufacturer, which is usually the out come of some innovative or intellectual creation. IPR are protected through, Copyrights, patents and trademarks given to the company by the state institutions.²⁷⁵ Efficient enforcement of IPR plays a decisive role in enhancing business opportunities and business growth in free market economy.²⁷⁶ In world market the demand of IPR protected goods are on increase, as they are considered to be reliable regarding quality. Similarly the investors are ready to invest in the SMEs using IP rights. The compliance of IPR solves the marketing problems of the SMEs of the developing countries by ensuring their access to diversified markets and GSC.²⁷⁷

The protection and registration of IPR rights in Pakistan can solve the problems of its SMEs by attracting the much needed FDI and investment in Research and Development (R&D). In Pakistan there are a number of IPR related laws but the basic problem is of their

²⁷³ The relationship between competition and industrial policies in promoting economic development, (2009), United Nations Conference on Trade and Development, The United Nations, Available at <http://www.unctad.org/en/ciclpd3en.pdf> (Accessed August 1, 2009), p 3.

²⁷⁴ Tran Viet Hung, (2007), SMEs and Supply Chains, Available at <http://www.unescap.org.pdf>, (Accessed July 21, 2009), p 6.

²⁷⁵ Competition Regime in Pakistan- Waiting for a shake-up, (2002), Sustainable Development Policy Institute (SPDI), Available at <http://www.cuts.international.org/pakistan.report.pdf> (Accessed August 1, 2009), p 18.

²⁷⁶ Pakistan Agenda for Action Interim Report (2008), United States Agency International Development (USAID), Business Climate Legal and Institutional Reform (BIZCLIR), p 26.

²⁷⁷ Tran Viet Hung, (2007), SMEs and Supply Chains, p 6.

effective implementation. The violation of IPR is a hot debated issue between Pakistan and various other countries especially the US. Pakistan was blamed for practicing counterfeiting practices in Pharmaceuticals and it became the major reason for failure of Pakistan-US Free Trade Agreement negotiations. This issue is marked as a potential trade barrier to trade and investment in Pakistan.²⁷⁸

For addressing the IPR issue the government of Pakistan should try to bring all the organizations dealing with IPR issues under a single management department. Computerized record of all the outstanding trade marks, patents and copyrights should be maintained. Awareness regarding the violation of IPR should be raised among the industrialist and the public. Similarly IPR enforcement activities should be coordinated and separate IPR courts should be established for speedy disposal of such disputes.²⁷⁹ Besides this the prevailing law and order situation in various parts of the country has the worst impact on the SMEs growth. Pakistani entrepreneurs are already encountered by financial problems and additional security measures. Hence for the promotion of entrepreneur culture in the country long term solutions should be devised for combating the current state of lawlessness.

²⁷⁸ Pakistan Agenda for Action Interim Report, (2008), United States Agency International Development (USAID), Business Climate Legal and Institutional Reform (BIZCLIR), p 26.

²⁷⁹ Pakistan Agenda for Action Interim Report (2008), United States Agency International Development (USAID), Business Climate Legal and Institutional Reform (BIZCLIR), p 36.

CONCLUSION

We started our analysis by stating the need for an effective legal framework for SMEs in Pakistan in the globalised world. The most important point in this regard was to link the Corporate Governance rules with combating the contemporary problems of SMEs in Pakistan. Undoubtedly the traditional concept of Corporate Governance only suitable for the LSI has changed. The emergence of Corporate Social Responsibility movement has obliged all the companies whether small or large to carry their activities within effective legal framework. After analyzing the contemporary issues of SMEs in Pakistan we conclude that it is the application of principles of Corporate Governance through which the SMEs in Pakistan can face the challenges of internationalization and globalization.

This study gives a general analysis of the contemporary Corporate Governance practices. However the major issue discussed in this thesis was to take a critical overview of the contemporary Corporate Governance practices from the perspective of the SMEs in Pakistan. Another issue was that how the trends of globalization are putting new impediments to the trade of developing countries, as was done to Pakistan by banning soccer balls made with child labour. This and many new international rules and regulations are the motives of the developed countries for advancing their capitalistic motives while pushing the developing countries towards further poverty and degradation. In this situation the SMEs which are the major economic contributors of the developed countries have to reassess their policies for making them more advanced and competitive.

The basic argument of the thesis was to discuss that how far the current Corporate Governance laws of Pakistan are effective in addressing the issues of SMEs in Pakistan. Access to finance and technology, lack of infrastructure, distorted market competition, violation of labour rights, regulatory burdens and many other corporate manipulative

practices are common in the SMEs sector of Pakistan. The Corporate Governance laws for SMEs in Pakistan are marked by various flaws which are deterring the SMEs to comply with them. The fragmented nature of laws makes it difficult for the SMEs to follow them. Voluntary compliance of these laws is another flaw, as law is hardly taken into account by the establishments until accompanied by sanctions. Similarly the application of labour safety specific laws to sizeable organizations makes the core labour laws of the state less effective for the SMEs. Pakistan despite being a signatory to the CLS and ILO conventions is often blamed for the violation of these standards in its industrial sector in the world market. The modern enterprises cannot ignore the environmental laws, but in Pakistan SMEs hardly pay any heed to such standards. Perhaps the most important issue on which the thesis focused is that attention should be given to effective implementation of laws rather than mere formulation, only then it can achieve its desired objectives.

The above mentioned analysis depicts that the current Corporate Governance laws of SMEs in Pakistan are not much effective in addressing their contemporary problems. Hence the first step in this regard is to introduce reforms for making the existing laws of Corporate Governance more simplified and SMEs friendly. SMEs should be relieved from excessive burdens of taxation and other regulatory charges thus encouraging their corporatization. Government should try to improve the access of SMEs to actionable information. This step will address the problem of counterfeiting of goods and distorted market competition common in this sector. SME policy 2007, no doubt a perfect SME oriented policy but its portion related to the implementation of policy needs to be reassessed to be more effective. The government needs to pay attention to solve the financial problems of SMEs by initiating micro financing schemes and developing cluster approach making them more competitive. Similarly SMEs should be encouraged to establish linkages with

GSC and comply with national and international environmental standards. The elements of lawlessness should be completely eradicated to encourage foreign direct investment and to restore the confidence of investors. By taking the above mentioned measures SMEs can be enabled to face the contemporary challenges of globalization.

The current study has only taken an overview of the most contemporary problems faced by the SMEs in Pakistan in the globalized world. However SMEs is an important sector of Pakistan economy and an in-depth study along with survey is required to determine their core issues. As there are some issues which come to the forefront after having a deep analysis from every perspective. This thesis just discussed the effectiveness of Corporate Governance for the SMEs from the perspective of its benefits to them in addressing the contemporary challenges. Finally the thesis stresses on the need for effective implementations of corporate governance laws on the SMEs.

The framing of effective legal setup for SMEs in Pakistan is taking its roots, the establishment of SMEDA, SME Bank and other reforms are good efforts on part of the government for encouraging and flourishing the entrepreneur culture. However the need of the hour is to assess the effectiveness of proposed legislation before its promulgation along with simplifying the existing laws. Hence future research is required regarding how far the proposed SMEs laws will be effective in solving their problems.

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