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Constraints to SME Development in Bangladesh

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I. Introduction

The development of small and medium enterprises (SMEs) in developing countries is generally believed to be a desirable end in view of their perceived contribution to decentralized job creation and generation of output. SMEs constitute the dominant source of industrial employment in Bangladesh (80%), and about 90% of the industrial units fall into this category. The actual performance of SMEs, however, varies depending on the relative economic efficiency, the macro-economic policy environment and the specific promotion policies pursued for their benefit.

For the JOBS Program, Zaid Bakht (1998) and Salahuddin Ahmad, et al. (1998) developed research papers that describe the policy environment within which SMEs in Bangladesh operate. The reports also discuss the accompanying legal, regulatory and administrative constraints to employment creation by SMEs. This paper attempts to highlight the findings of those two studies. To complement the issues discussed in those two papers, a summary of industrial problems, as perceived by entrepreneurs during the past one decade (HIID, 1988; MCCI 1992; World Bank 1994; JOBS 1998), is also presented in this report.

II. SME Development in Bangladesh

Historically, Bangladesh followed a development strategy in which private investment was controlled through a host of regulations involving investment sanctioning, credit disbursement, import licensing, foreign exchange allocation, etc. While these regulatory barriers thwarted private investment in general, the impact fell unevenly on SMEs. This was because of the relative inability of the SMEs to cope with the regulations compared to their large-scale counterparts. Thus, the policy regime was largely biased against the SMEs although, paradoxically, promoting SME development was a stated objective of successive governments.

In a bid to render its industrial sector internationally competitive and to move towards greater efficiency in its production structure, Bangladesh implemented a number of economic reforms during the 1980's, underwritten by the familiar structural adjustment policy. These included deregulation of sanctioning procedure and relaxation of other regulatory barriers, easing of import procedure, reducing trade barriers, following a market oriented exchange rate policy, and implementation of fiscal, monetary and public enterprise reforms.

These reforms helped remove a large part of the policy bias against SMEs that prevailed earlier. Recent studies confirm that these reforms had positive impacts reflected in a fairly rapid growth of the sector during the past decade. However, because of their structural weaknesses, the SMEs may need more pro-active policies for their development in addition to the further removal of the policy biases.

III. Policy Issues

Public Development Outlay

Although successive five-year plan documents have mentioned development of small, medium and cottage enterprises as priority area, public development expenditure in this sector has not been commensurate with this declared policy. Thus, in the Fourth Five Year Plan, the revised public allocation to this sector was Taka 2,016 million which was a meager 0.58 per cent of the total public development outlay in the plan. What is even worse, only about 69 per cent of this small allocation were actually invested during the plan period. In the current Fifth Five-Year Plan, the share of the sector in total public development expenditure has gone down even further. If the sector has to make much headway, there is need for substantial increase in public investment in the sector particularly in the area of training, extension, research, market promotion, etc. A collaborative effort of the government with business associations, non-governmental organizations NGOs and other development partners is recommended in such public outlays.

Trade Policy

During the past decade, substantial reforms have been carried out in the external trade regime of Bangladesh. The import procedure has been greatly eased and deregulated. Import tariffs have been lowered and quantitative restrictions virtually eliminated. All these have facilitated greater access of domestic producers to imported raw materials. This has particularly benefited SMEs as they were affected more adversely by the regulated trade regime.

However, import liberalization has also exposed domestic producers to competition from foreign goods. To ensure a level playing field and to enable domestic SMEs to compete effectively with imports, the following policy concerns need to be addressed.

Prior Announcement of Policy Changes: To enable domestic producers, particularly the SMEs, to prepare themselves to face external competition there is need for adequate forewarning about impending policy direction. This is particularly true of trade policy measures. If the government makes prior announcements of its impending trade policy changes, particularly with respect to tariff schedules, investors will be aware of the degree of competition they will be facing with the changes and will make adjustments in their investment and production plans accordingly.

Tariff Rationalization: To encourage domestic production, there should be adequate gap between duty on raw materials and duty on finished products. In fixing duty on finished products, possible under-invoicing and dumping should be taken into account, as otherwise, effective duty rates on finished goods will turn out to be lower than that on raw materials in spite of the higher statutory rate on the finished item.

Appropriate Tariff Valuation: To avert the problem of under-invoicing, a system of tariff value has been put in place for certain categories of imports. There are complaints that these tariff values are often not in line with the going world price of these items which sometimes puts domestic producers at a relatively disadvantaged position.

Fiscal Policy

Value Added Tax: The main components of indirect tax in Bangladesh are Value Added Tax (VAT), Supplementary Duty and Excise Duty. VAT is imposed on producer, manufacturer, importer, exporter or service renderer under the Value Added Tax Act, 1991, on goods or specified services, at the rate of 15% at every stage of transfer. VAT paid against the input is adjustable against the VAT on output to be collected from the buyers and the net sum stands payable on delivery of goods or specified services to the VAT authority. Exemption is allowed to certain goods or service or certain taxpayers.

All cottage industries, except those producing particular products, are exempted from VAT. But, manufacturer, producer or service renderer (other than cottage entrepreneurs), whose annual turnover does not exceed Taka 1.5 million are required to pay Turnover Tax at the rate of 2.5 per cent in lieu of 15 per cent VAT. This limit is too low for small industries. As a result, small industries are subjected to the same 15 per cent VAT as their large-scale counterparts. In addition, supplementary duty is imposed at variable rates on certain categories of consumption goods across all size categories. Finally, excise duty applies to a limited number of items irrespective of size classification.

Thus, in terms of indirect taxes, there is virtually no differentiation between SMEs and their large-scale counterparts, which is considered inequitable by most SMEs.

Tax Holiday: Similarly, there are no differentiated treatments of SMEs either with respect to duty on capital machinery or direct taxes. There are provisions of tax holidays for enterprises of all size categories subject to rules and procedures set by the National Board of Revenue. To avail themselves of tax holiday, enterprises recommended by the relevant sponsoring agencies have to get the approval of the National Board of Revenue which is a cumbersome and lengthy process. The tax holiday, however, is not available to sole proprietorship enterprises which are the usual form of small and cottage industries in Bangladesh.

***Wealth Tax*:** Wealth tax is payable by an individual if his net wealth exceeds Taka 2.5 million. As per existing law, no wealth tax is payable by a company, the usual legal form of a large industry. On the other hand, the legal form of small industries is usually sole proprietorship, and hence these enterprises have to pay wealth tax on their business capital.

Thus, fiscal policy in Bangladesh is not particularly tailored to provide support to SMEs, which is pointed out by most SME entrepreneurs as a critical policy constraint hindering SME growth.

SMEs and NGOs

SMEs appear to be facing discriminatory competition from the commercial activities of NGOs. On the other hand, smaller units may be receiving valuable assistance in the form of training or market information from the NGOs. NGOs should be promoting small businesses and not themselves become competitors – crowding out private enterprises. Further research and debate on the role of NGOs in promoting SMEs is propounded.

IV. Legal, Regulatory, and Administrative Constraints

As mentioned earlier, policy reforms of the past decade have brought about substantial relaxation in the investment sanctioning procedure. No prior approval is now required for investments involving own finance. However, there is scope for further improvement in the following procedural aspects relating to investment regulations:

Trade License: Investors are required to procure trade license from local government bodies by paying statutory fees. The process involves unnecessary delays, harassment and side payments. The procedure needs to be simplified and the issuance of the license made automatic subject to payment of requisite fees and declaration by the investor that the proposed investment is in conformity with the rules and regulations and zoning restrictions of the local government authority.

Registration under Factories Act: According to the Factories Act 1965, all manufacturing units employing 10 or more workers are required to be registered with the office of the Chief Inspector of Factories and Establishments. The job of the Factory Inspector is to oversee the working condition and safety measures in the factory. In practice, the regulation has proved to be a major source of delay, harassment and unofficial payments for the investors particularly for those in the SME sub-sector as the existing regulations do not differentiate between different size categories with respect to safety and working conditions requirements. To relieve the investors of these problems the requirements relating to safety and working conditions should be defined separately and realistically for the SMEs and the discretionary powers of the Inspector should be minimized. Registration should be automatic once the investor has declared that the requirements have been complied with.

Clearance from the Department of Environment: All industries are also required to obtain a certificate from the Department of Environment in respect of proper arrangement for anti-pollution and safety measures. Here again, the requirements should be clearly stated for the type and size categories of industry and the investor should be allowed to go ahead with investment on the basis of the undertaking that the requirements will be complied with.

Registration with Sponsoring Agency: Registration with sponsoring agencies such as the Bangladesh Small and Cottage Industries Corporation (BSCIC), Board of Investment (BOI) or Bangladesh Export Processing Zone Authority (BEPZA) is voluntary unless an enterprise wants to avail itself of government incentives. To keep track of private investment in various sub-sectors, it would be useful to make registration with the sponsoring agency mandatory. However, to relieve the investors of possible hassles, registration procedure should be simplified requiring minimum information to be provided by the investor, and registration should not be held up until the proof of investment has been produced as the current practice appears to be.

Contract Enforcement and Resolution: This is a constraint, which is faced by both large and small firms. Inadequacy in the system for contract enforcement and resolution arises from archaic legal system where procedure of adjudication is long drawn out and cumbersome and the system is corrupt. As a result it is not difficult to delay a scheduled date for hearing. SMEs with low sustaining power often lose out in the long drawn out court battle.

V. Financial Constraints

Access to Finance: SMEs encounter great difficulties while raising fixed and working capital because of the reluctance of banks to provide loans to SMEs. Banks are shy to lend to SMEs because of high processing and monitoring costs of loans to SMEs. The loan application forms for investment financing from banks are long, tedious, and redundant. Since the removal of the interest rate subsidy without the removal of interest band, financial institutions find little incentive to lend to SMEs. SMEs find it difficult to use non real estate assets as collateral to obtain loans from the banks.

In the past, the government has attempted to provide SMEs with access to finance through targeted lending. There was a government directive that 5 per cent of a bank's loan portfolio be set aside for small and cottage industry financing. A new bank, namely, the Bank of Small and Cottage Industries (BASIC) was set up in 1988 with the objective of financing the small and cottage industries. There were also attempts to channelize fund received from international agencies such as the Asian Development Bank (ADB) to the sector through private banks. There were provisions of favorable debt equity ratio, special interest rates and credit guarantee scheme. The central bank also issued directives to both public and private commercial banks regarding working capital loans, use of standardized documentation procedure and time limits for credit sanctioning and loan disbursement.

Notwithstanding all these arrangements for financing of SMEs, the actual delivery of institutional credit to this sector has been grossly inadequate. The following seem to be the key factors inhibiting flow of institutional finance to the sector.

Project Preparation and Evaluation: The first problem entrepreneurs face in seeking institutional finance is with regard to preparation of the project proposal. In spite of directives from the central bank to follow standardized procedure, the loan application process has still remained lengthy and cumbersome. The entrepreneur often lacks the ability to formulate a proper project proposal. Even when he prepares the proposal drawing on outside expert services, there is no guarantee that the proposal will be evaluated properly as the financial institutions themselves lack adequate capability for proper project evaluation.

Collateral Requirements: One of the main factors that have hampered flow of institutional finance into SMEs is banks' pre-occupation with collateral based lending. Traditionally banks have used fixed asset ownership, particularly land ownership as the basis for judging credit-worthiness. This puts SMEs at a relative disadvantage, as large entrepreneurs are often able to get around the problem because of their influence and contacts by putting up collateral of dubious valuation. The solution to this problem lies in banks seeking deposit relationship with owners of SMEs and using cash flow rather than asset ownership as the criterion for credit-worthiness. An expanded credit guarantee scheme will have to play a vital role in this regard.

Bureaucracy and Corruption: Because of lack of proper autonomy and accountability the public sector financial institutions are beset with inflexibility, inefficiency, political interventions and corruption. Since the performance of the bank officials is not properly evaluated they lack the incentive to bring a large number of suitable borrowers, particularly those in the SME sector, within the fold of institutional financing. They adopt a passive and inflexible attitude towards the borrowers either to avoid the risk of making an inappropriate lending or to force the borrower to make side payments for more favorable handling of the loan application. Until necessary reforms in the public financial institutions are carried out, the SMEs will continue to bear the brunt of this institutional malice.

VI. Major Industrial Constraints – A Historical Perspective (1988-98)

There is a growing literature on various constraints that have impeded the growth of SMEs in Bangladesh. Many of the constraints presently encountered have been discussed in the preceding section. In this section, a summary of the findings from selected studies, during the 1988-98 period, is being presented.

Major Findings: Over the years, various studies have been conducted to identify constraints encountered by entrepreneurs in the industrial sector. A summary of the ranking of the problems from selected studies over the 1988-98 period is presented in this section. Table 1 provides the ranking of the top eight problems according to the recently completed survey of eight SME subsectors under the JOBS program. The subsectors include: Steel Furniture, Small Metal Works and Light Engineering, Electrical Small Goods, Plastic Products, Specialized Handloom, Bakeries, Textile Dyeing and Printing, and Footwear. According to Table 1, electricity, credit, and law and order are respectively the three top ranked problems followed by legal barriers, excess competition, and dearth of technical assistance.

Relative ranking under selected past studies of the top eight problems, identified under JOBS, is presented in Table 2. As evidenced in Table 2, points are awarded only if a problem was ranked as one of the top five under each of the respective studies (5 = most serious). A summation of the scores from the various studies reveals that credit and working capital have consistently remained as the major bottlenecks to industrial growth in Bangladesh. Electricity problem is also ranked close to credit as a serious problem at present and in the past. Unavailability and/or high price of raw material, poor law and order conditions and legal barriers are cited as serious problems, but not as highly as credit and power.

VII. Conclusions

The studies reviewed reveal that SMEs have received disproportionately smaller support from the government in terms of policy or fiscal incentives. SMEs, as a group, are weak in echoing their needs and demands.

There have been improvements in the sanctioning and other administrative procedures affecting SMEs; further simplification, transparency, and accountability are necessary to promote SME development.

A wide array of constraints faced by SMEs have been briefly discussed in this report. It is apparent that problems related to power and credit are the two most significant ones. Legal barriers, poor law and order conditions, are some of the other problems that have adverse affect on SME development.

The JOBS program should identify and promote innovative means towards addressing the credit problem phenomenon. In the area of legal reform also, JOBS may pursue further work. Problems related to power and law and order conditions are well known, and continued pressure from the business community, NGOs and others are collectively needed to bring about improvements.

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Table 1: Rank of SME Constraints -- JOBS Study 1998

Problems	Rank
Electricity	1
Credit & working capital shortage	2
Poor law & order	3
Legal barriers	4
Excess competition	5
Technical assistance	6
Marketing	7
Raw material price	8

Source: JOBS/USAID, 1998

Table 2: Industrial Problems 1988 - 98

Problems	Year							
	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94	1997-98	Unweighted	Weighted
Electricity	5	4	3	1	5	5	5	28	20
Credit & working capital	4	5	5	5	4	3	4	30	21
Poor law & order	3	0	0	0	0	4	3	10	8
Legal barriers	0	0	0	3	1	0	2	6	5
Excess competition	0	3	0	0	0	1	1	5	3
Technology	0	0	0	4	0	0	0	4	3
Marketing	0	0	0	0	2	0	0	2	2
Raw material price	0	0	4	2	3	2	0	11	8

Source: 1997- 98 -- JOBS/USAID; 1993-94 -- ISS/World Bank; 1992-93 -- ISS/World Bank; 1991-92 -- MCCI; 1990-91 -- World Bank; 1989-90 -- HIID/USAID; 1988-89 -- HIID/USAID