IMPACT OF FINANCIAL AND NON-FINANCIAL SERVICES ON THE PERFORMANCE OF MICRO, SMALL AND MEDIUM ENTERPRISES IN PUNJAB, PAKISTAN

BILAL AHMAD

ASIA e UNIVERSITY
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BILAL AHMAD

A Thesis Submitted to Asia e University in
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ABSTRACT

Micro, Small and Medium-sized Enterprises (MSME) have been the lifeblood of economies across the globe, as they play a pivotal role in steering economic growth, nurturing modernisation, and creating employment opportunities. They rely on financial resources like any business model; such financial resources could be in the form of Financial Services and / or Non-Financial Services (NFS). Research has shown that Financial Services play a crucial role in promoting the influence of SMEs on economic growth, entrepreneurship, and job creation. Additionally, NFS has been studied in conjunction with Financial Services, and their combination has further enhanced the impact of SMEs on both national and global economies. Nonetheless, developing economies such as Pakistan lack organised data or research that could be helpful for policy and practice, except for some research on financial services. Thus, this study has been deployed to assess the combined impact of financial and non-financial services on performance, using business survival, profitability, and job creation by the MSMEs. With a cross-sectional design, the exploratory study employed primary data from survey questionnaires from 400 MSMEs. This study was set in Punjab and focused on the province's central region. Data was analysed using SPSS and SmartPLS. Results revealed that financial services individually had a positive and significant impact on survival, profitability, and employability, while this positive impact was amplified when non-financial services were added to the equation. In conclusion, NFSs are as important as financial services for the overall performance of MSMEs, particularly for developing economies like Pakistan.

Keywords*:* MSME development, organisational performance and growth, financial and non-financial services, SME challenges, financial inclusion

APPROVAL

This is to certify that this thesis conforms to acceptable standards of scholarly presentation and is fully adequate, in quality and scope, for the fulfilment of the requirements for the degree of Doctor of Philosophy.

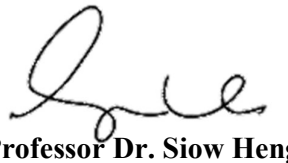
The student has been supervised by: **Prof Dato' Dr Sayed Mushtaq Hussain, SOM, AeU**

The thesis has been examined and endorsed by:

Prof Dr Juhary Ali,
Asia e University (AeU)
Examiner 1

Prof Dr Roslan Abdul Hakim,
Universiti Utara Malaysia (UUM)
Examiner 2

This thesis was submitted to Asia e University and is accepted as fulfilment of the requirements for the degree of Doctor of Philosophy.



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Asia e University
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(1 August 2024)

DECLARATION PAGE

I affirm that the dissertation presented for completing the PhD program is my work, and I have appropriately and accurately cited all contributions from other individuals or sources. Additionally, I confirm that this material has yet to be previously submitted, either in its entirety or partially, for a degree at this or any other university. By making this affirmation, I am aware that any violations of this affirmation constitute academic misconduct, which could lead to my expulsion from the program and/or disqualification from receiving the degree.

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Signature of Candidate: **Date**: 1 August 2024

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"Allah is sufficient for me; there is no GOD but He. In Him, I have put my trust. He is the Lord of the Mighty Throne"- Al-Quran

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LIST OF ABBREVIATIONS

ADB	Asian Development Bank
BDS	Business Development Services
CGAP	Consultative Group to Assist the Poor
CGS	Credit Guarantee Scheme
DFID	Department for International Development
EBIT	Earnings before interest and taxes
GDP	Gross Domestic Product
GoP	Government of Pakistan
GSI	Global Slavery Index
HR	Human Resource
IFAD	International Fund for Agricultural Development
KfW	Kreditanstalt für Wiederaufbau
ME	Micro Enterprises
MFBs	Microfinance Banks
MFIs	Microfinance Institutions
NBMFI	Non-Banking Microfinance Institutions
NFAS	Non-Financial Advisory Services
NFS	Non-Financial Services
PBS	Pakistan Bureau of Statistics
PKR	Pakistan Rupee
RoA	Return on Assets
RoE	Return on Equity
RSPs	Rural Support Programmes
SBP	State Bank of Pakistan

SECP	Securities and Exchange Commission of Pakistan
SEDF	Sindh Enterprise Development Fund
SEM	Structural Equation Modelling
SME	Small and Medium Enterprises
SMEDA	Small and Medium Enterprise Development Authority
TQM	Total Quality Management
U. N.	United Nations
USD	United States Dollars
VIF	Variance inflation factor

CHAPTER 1

INTRODUCTION

1.0 Background of the Study

The government of Pakistan has embarked upon several policies and institutional transformations to enhance credit accessibility from the financial sector to Micro Small and Medium Enterprises (MSMEs). Most MSMEs have yet to see improvement in entrepreneurial activities. Making credit available to MSMEs, specifically in the informal sector, most commercial lenders typically view lending as high-risk. Consequently, banks and other financial institutions (FI) are generally unenthusiastic about offering credit facilities to MSMEs.

Encouraging comprehensive economic progress relies on the efficient functioning of a sector comprised of small and medium-sized businesses, often where a significant proportion of the population is employed and engages in various economic endeavours (Zhiri, 2017). SMEs are considered essential agents for economic change and growth. Sure, here is the reworded text:

They play a crucial role in modernizing and advancing technology, providing skilled labour and raw materials to larger corporations, and driving entrepreneurship and business growth. (Sanusi, 2003).

The foundation of this study is rooted in the pivotal role that MSMEs play within global economies, especially within developing nations. These enterprises stand as crucial contributors to job creation and the advancement of worldwide economic progress (World Bank Group, 2019). On a global scale, SMEs comprise around 90%

of all businesses and are responsible for over 50% of total employment. Their formal representation within emerging economies contributes up to 40% of the national income, a figure that rises even higher with the inclusion of informal SMEs (World Bank Group, 2019). Recognising the imminent need for 600 million jobs by 2030, as projected by the World Bank in 2019, amplifies the significance of MSME development on a global scale.

Within emerging markets, SMEs emerge as powerful generators of employment, generating seven out of every ten jobs (World Bank Group, 2019). This importance is reflected in Pakistan, where small and medium-sized enterprises make a substantial contribution to the country's economic development, progress in technology, and overall economic well-being. They function as vital links between large industries, cottage enterprises, and broader economic rejuvenation, demonstrating their capacity to mitigate poverty and foster national economic expansion. In the diverse economic terrain of Pakistan, small and medium-sized enterprises (SMEs) make up over 90% of private businesses and provide jobs for almost 78% of the non-agricultural workforce, making a significant contribution to the Gross Domestic Product (GDP), which surpasses 30%. Furthermore, their influence extends to exports, as SMEs contribute to 25% of manufactured goods exports and add 35% of the value to manufacturing. (PBS, 2011).

Small and Medium businesses in Pakistan have made undeniable contributions, but they have been facing persistent challenges that prevent them from performing to their full potential. These challenges are particularly noticeable in their ability to generate profit, maintain service quality, and create employment opportunities. Many small businesses need help to remain operational, while others underperform, resulting

in suboptimal economic outcomes (Mahmood et al., 2018). This scenario has evoked considerable interest among researchers, policymakers, and practitioners to understand the underlying factors and devise strategies for improvement (Raza et al., 2021).

Despite their economic significance, Pakistan's MSMEs sector grapples with various constraints that hinder their potential to embrace economic liberalisation and fully exploit burgeoning international markets. These obstacles encompass limitations in product value addition, inadequate business information infrastructure, energy shortages, strategic planning gaps, financial literacy deficiencies, and restrictive lending practices by financial institutions. These impediments collectively restrain the growth and adaptation of MSMEs, underscoring the urgency for comprehensive support mechanisms.

Recognising the crucial role of MSMEs in economic diversification, job generation, and income elevation, the Government of Pakistan (GoP) has devoted significant efforts and resources to promoting entrepreneurship and fostering growth in MSMEs with the goal of poverty alleviation. Initiatives like the Small and Medium Enterprise Development Authority (SMEDA) and specialised government departments demonstrate this commitment. However, many shortcomings, including inadequate access to finance, persist within Pakistan's MSME landscape, curtailing their ability to tap into global markets and capitalise on economic opportunities.

The absence of credit accessibility significantly contributes to the financial limitations experienced by small and medium-sized enterprises. Despite being potentially favourable credit risks, MSMEs often encounter hurdles in securing funding due to their limited collateral. Information asymmetry exacerbates this challenge, where borrowers possess greater insight into their creditworthiness and

repayment capabilities than lenders. These financial barriers can significantly curtail MSME growth, a fact emphasised by the widespread acknowledgement that SME expansion is a linchpin of job creation, entrepreneurship development, and global economic transformation (Abor & Quartey, 2010; Katua, 2014; Lozano-Reina & Sánchez Marín, 2019; OECD, 2017; Taraki, 2019).

While many policies and institutional changes have been implemented to support the flow of credit to small and medium-sized enterprises, the outcomes have not met expectations. Commercial banks, seeing SMEs as high-risk investments, are hesitant to provide them with credit, mainly because of transaction costs, limited data, and short repayment terms (Lwesya et al., 2021). Moreover, small and medium-sized enterprises (SMEs) in the informal sector are especially affected by the lack of access to credit, particularly in regions where they have the potential to make a significant contribution to economic growth and the reduction of poverty (Lwesya et al., 2021).

For Asian economies, similar challenges hinder SME growth. Inadequate capital, limited market insights, outdated technologies, insufficient training, and restricted access to advisory services impede small and medium sized businesses progress. Non-monetary assistance services, which include a variety of services for business growth, can act as a solution for these non-monetary obstacles, promoting competitiveness, improvement of product quality, and increased profitability. These services include business education, coaching, advising, technology sharing, networking, marketing knowledge, and help with exporting. (Miehlbradt & McVay, 2003; Radipere & Van Scheers, 2014).

The existing research indicates a notable gap in understanding how to enhance the performance of SMEs/ MEs in Pakistan, especially in the area of non-financial

services (NFS). Although the significance of finance for SMEs in Pakistan is widely recognised, there is a noticeable absence of a comprehensive study exploring the potential of NFS interventions to enhance SMEs'/ MEs access to finance and overall performance, a topic that has not been adequately discussed in scholarly circles. (Aamir & Shah, 2018).

There is a lack of research data on how NFS affects SMEs and their ability to tackle the various obstacles these businesses face. It is vital to carefully study the financial environment for MSMEs in Pakistan. SBP's SME Finance review at YE2023 depicts a stark picture, with only 6.05% of the entire Domestic Private Sector Financing allocated to SMEs. Commercial lenders hesitate to extend credit to SMEs. This alarming statistic highlights the urgent need for policy changes and the pressing need to explore innovative avenues to bridge this gap and invigorate economic activity within SMEs.

Although microfinance organisations help fill the credit gap, there has been limited research dedicated to examining the impacts of both financial and non-financial services on MSMEs. Previous research, such as (Haider et al., 2017) study on entrepreneurial skills training and (Ul-Hameed et al., 2018) research on microfinance and women's empowerment, provides valuable insights into potential methods for improving SME performance. Similarly, (Malik et al., 2010) "work highlights the importance of Total Quality Management (TQM) practices in influencing the non-financial performance of SMEs". However, these studies only focus on specific aspects of SME development, leaving a comprehensive understanding of the combined effects of FS/NFS interventions that could be explored more.

The research gap is important and has been studied extensively worldwide. (Abdullah & Sofian, 2012) have highlighted the connection between SME performance and intellectual capital, while (Chen et al., 2006) have emphasised its pivotal role in knowledge-based economies. Studies such as (Dikko et al., 2014; Babalola, 2013) have also recognised the significance of combining financial and NFS, "which have examined their impacts on entrepreneurship and community development".

With the intention to fill this research gap, this study aims to conduct a practical investigation into the effects of combined financial and NFS on the survival, profitability, service quality, and job creation potential of MSMEs. The emphasis on the Punjab Province, which represents a substantial portion of Pakistan's population and economic activity, enhances the study's significance. This research aims to produce valuable insights that can aid the decision-making processes of stakeholders, such as the SBP, the Securities and Exchange Commission of Pakistan (SECP), financial institutions, microfinance banks, and non-bank microfinance institutions (NBMFIs). Through this effort, the study seeks to lay the foundation for a more dynamic, inclusive, and resilient economic ecosystem in Pakistan.

Although the significance of these factors is recognised, there is still a research gap when it comes to examining the combination of financial services and non-financial services and how they collectively impact the performance of MSMEs. This research aims to fill this gap by studying the influence of different types of services on MSMEs operating in the Punjab Province of Pakistan. The study will evaluate the survival rates and profitability to determine the overall impact of these services on the performance of MSMEs. Furthermore, the study will analyse the effectiveness of the

various services provided by financial institutions, questioning whether they genuinely stimulate the growth of MSMEs.

1.0.1 SME Policy Framework

The SME sector was recognised as pivotal for the economic revival plan outlined by the Government of Pakistan (GoP) in 1999-2000. In January 2004, the GoP established a Task Force for SME Policy Development to formulate a framework aimed at fostering the growth and advancement of SMEs. The SME Policy, 2007 was created to promote the sector's growth and accomplish the government's objective of sustainable development in the long run. The evolving global context and internal factors necessitated a reassessment of the policy framework overseeing the sector, leading to the development of the National SME policy in 2021.

It serves as a guiding document that takes account of the challenges faced by the SME sector to produce a detailed policy guide to support and guide the implementation of reforms in the SME sector. In 2018, the Federal Government notified a National Steering Committee of public and private sector representatives to develop a new National SME Policy.

Following this notification, the National Steering Committee formulated the National SME Policy 2021, which serves as a blueprint offering recommendations to bolster the growth of SMEs. Under its mandate, CCP deemed it necessary to review the policy framework, conduct a research study on the SME sector, and offer recommendations based on extensive fieldwork.

The importance of the study is centred on its examination of the difference between the expected potential and the actual performance of small and medium-sized enterprises (SMEs) in Pakistan and the impact of financial support and non-financial

services on this divergence. By addressing these concerns, this study could offer valuable insights for decision-makers and stakeholders seeking to enhance the performance of the SME sector and its contribution to the Pakistani economy. SMEs are vital for the economic progress of any nation, and Pakistan is no different. In Pakistan, SMEs have the potential to significantly contribute to economic expansion and job creation and serve as a source of foreign exchange earnings through exports.

1.0.2 Economic Growth

The micro, small and medium sector entities play a significant role in the country's economic development. This sector is considered the backbone of any economy, and Pakistan is no exception. According to SMEDA and SBP, “there are over 5 million SMEs in Pakistan, which account for 40% of Pakistan's GDP and 25% of overall exports”. Following the agriculture sector, the SME sector provides employment to the highest percentage of the working population in the country, contributing to 78% of non-agriculture sector employment. Reducing poverty, expanding the national economy, and creating jobs are among the primary roles of SMEs.

Pakistan's economy has long been characterised by a significant presence of SMEs in various sectors, including manufacturing, services, and agriculture. These businesses are crucial in promoting innovation, entrepreneurship, and regional development. (Khan & Akhtar, 2020) research emphasises the importance of SMEs in Pakistan's economic landscape, highlighting their contribution to GDP growth, employment generation, and poverty reduction. SMEs contribute directly to economic output and act as key suppliers and service providers to more prominent industries, expanding their impact on economic growth.