Inclusive Finance for SMEs in Pakistan: A Supply-Side Perspective

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**ARTICLE DETAILS**

**ABSTRACT**

**Objective:** Inclusive finance aims to escalate the access and usage of financial services among SMEs and individuals as well. Therefore, it is mainly concerned with efforts towards financial inclusion, which means easy access and usage of a wide range of affordable financial products and services by everyone, provided by a variety of sound, responsible, and sustainable financial institutes. In Pakistan, SMEs face severe issues towards access to formal finance and bound to meet their financial needs by using informal finance. This study aims to highlight the supply-side factors impacting SME’s access to finance in Pakistan.

**Methodology:** This quantitative research has been conducted in the five big cities of Punjab province. By using a stratified sampling technique SMEs from three main sectors have been included in this study manufacturing, services and trading.

**Findings:** In line with prior research study concluded that for inclusive growth and development, provision of resources, favourable policies and regulatory reforms, financial and other national institutions, international bodies support can bring significant change in the status of SMEs in Pakistan.

**Implications:** Current study will be helpful for policy makers and financial institutions to formalize their structure and strategies to facilitate SMEs in Pakistan.

**Keywords**  
SMEs, inclusive finance, financial inclusion, Pakistan

**JEL Classification**  
M1, M2

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**Introduction**

For the creation of inclusive, dynamic, and competitive economies, Small and Medium Enterprises (SMEs) play a pivotal role. These firms are crucial for job creation and economic growth which in turn helps in poverty elimination and boosting shared prosperity. The contribution towards the achievement of Sustainable Development Goals (SDGs) such as; zero poverty, gender equality, decent work and economic growth, and women empowerment has been recognized. Economic development can be ensured by catering to various issues such as access to
finance hindering the growth of SMEs. For inclusive growth and development provision of resources, favourable policies and regulatory reforms, financial and other national institutions, international bodies support can bring significant change in the status of SMEs. Thus, for SMEs formation and growth, fostering a conducive environment is decisive (IFC, 2022).

The concept of inclusive finance is interrelated closely with more general notions of inclusive growth and development. The importance of finance inclusion is widely recognized by policymakers and world leaders because of its central role in sustainable development. Inclusive finance aims to escalate the access and usage of financial services among all sectors including SMEs. Therefore, it is mainly concerned with efforts towards financial inclusion, which means easy access and usage of a wide range of affordable financial products and services by everyone, provided by a variety of sound, responsible, and sustainable financial institutions. According to the Millennium Development Goals Framework, the concept follows the commitment of ‘leave no one behind’. The most disadvantaged society segments living in poverty can get financial products and services to develop their businesses to shield themselves from adverse shocks (Corrado & Corrado, 2017).

Current study is shedding light on immense important sector of SMEs playing key role in gross domestic product (GDP) in sustaining viable economies in developing countries. According to the statistics, 99% of enterprises in almost all countries are SMEs, and numbers increasing aggressively. Furthermore, most of the formal jobs are generated by SMEs, around 90% of employment opportunities globally and in emerging economies are provided by SMEs. By 2030, to absorb growing workforce globally, 600 million jobs will be required, which is not possible without emphasizing on SMEs (World Bank, 2022).

Experts and policymakers consider SMEs as the backbone of economy, despite, the sector face multiple barriers restricting their survival and growth in emerging economies. Researchers highlighted several financial and non-financial constraints facing by SMEs in developing countries such as;

- Access to finance
- Inefficiency in skilled labour
- Legal, regulatory, and administrative issues
- Absence or lower adoption of technology
- Lack of market information and market access
- Improper infrastructure
- Rising costs and reduced revenues
- Lack of economies of scale and scope
- Limitations of networking helps to provide information and experience of international and domestic markets
- Market competition, globalization
- Inability to compete in terms of research and development and innovation

Access to finance indicated by various studies drastically impede the growth and development of SMEs (Yoshino, N. and F. Taghizadeh-Hesary, 2016). In developing economies, SMEs face significantly more constraints towards access to finance as compared to larger firms. SME Finance Forum annual report (2021) statistics revealed that around 131 million (41%) of formal micro, small and medium enterprises have unmet financing needs in developing countries. The unmet credit demand is estimated about USD 4.5 trillion (IFC, 2022). Further, out of 78 million SMEs in South Asia, only 34 million have bank accounts, with 11 million having a loan or overdraft. The statistics shows a funding gap of 36 million businesses that are underserved, either
have no access to formal finance or no support of getting finance. Asian Development Bank report (2021) exhibits that total finance gap by 2020 is 5.2$US trillion and the potential demand is 8.9$US trillion, similarly figure 2 displays the percentage of financially constrained SMEs by region.

The non-availability of funding prevents SMEs in developing countries such as Pakistan, to realize their potential as an economic engine. Easy access to finance helps firms to expand as per the requirements of the market, and adopt changes quickly to compete and become economically stable. In Pakistan, the Small and Medium Enterprises Development Authority (SMEDA) working aggressively to strengthen the SME sector. SMEDA defines SMEs on the basis of firms' annual sales turnover; firms up to PKR 150 million categorized as small enterprises and those above PKR 150 million to PKR 800 million fall under medium enterprises (SMEDA, 2023). Around 5.2 million businesses in Pakistan comprised of small and medium firms, contributing 40% towards GDP, 30% to the total exports and 80% employment to non-farm labour. A study conducted by Fouiejou et al., (2020) presented an index of MENAP (Middle East, North Africa, Afghanistan and Pakistan) and CCA (Caucasus and Central Asia) regions. The results show highest level of SME financial inclusion in the region of Tunisia, Lebanon and Morroco. However, Pakistan, Yemen, Iraq and Afghanistan fall in the lowest level of SME financial inclusion.
Similar to other developing countries SMEs in Pakistan also wedged in intense challenges such as onerous taxation regime, higher costs, sector policy distortions, and access to finance. Formal SMEs find themselves at a detriment while competing with the informal sector, moreover, through withholding approximately 70% of taxes paid by the sector and in case of any violation, liable for penalties (Akhtar & Hassan, 2023). For the development of this economically least integrated group, quick and hassle-free provision of finance is crucial, whereas, access to finance has been enlisted by various studies as a major obstacle.

SME sector growth in Pakistan hindered by various demand-side factors such as, lack of awareness, low interest in formal financing, lack of financial knowledge, inability to provide collateral, lack of skills, owner-manager social and religious binding. Similarly, from supply-side misalignment between SMEs needs such as unsecured loans, trustworthy convenient channels, ecosystems, supply chain linked solutions, working capital finance, transactional solutions and business linked embedded solutions, and available banking products in market also prevent SMEs from obtaining finance. Along with this, high-interest rates, collateral requirements, high transaction costs, risk of default, longer time to process loan applications etc. resulted increased share of informal financing in SME sector (Rasheed & Siddiqui, 2022).

To fulfil their financial needs SMEs either used formal or informal sources of finance. The financing capital provided by the banks and non-banking financial institutions to businesses, known as formal finance. The firm owner-managers borrow from family, friends, relatives, suppliers, and other private money lenders to fulfil their financial needs, known as informal finance. Formal finance follows the principle of arm-length and is based on hard information, whereas, informal finance process completed by both parties on the basis of soft information and relationship-based principles. Firms’ owner-managers face trade-offs in deciding the suitable financing source for their businesses as both differ with respect to capital financing contracts. Several studies discussed that informal financing sources are more attractive for owner-managers as compared to formal finance, because of quick process, lower transaction fees, and no or less collateral requirements (Nguyen and Canh, 2021). However, the informal network of financiers facilitates SMEs by giving small loans for a limited time period, without any interest obligation on the lender. Usually, these types of networks consist of family, friends and referrals who extend their support based on some relationship. Alternatively, professional money lenders exploit the borrowers by asking for higher interest rate and other unfair terms and conditions. SMEs in the rural areas of Pakistan most of the time arrange their funding from money various informal sources. In these underdeveloped areas, SMEs such as farmers asked for finance to purchase machinery and fertilizers, and most of the time they even could not afford to buy and use the rented ones to fulfil their requirements. In an informal setup, lenders do not ask for any collateral however, asked for a fixed portion of profit at the time of harvesting. In addition, borrowers have
to pay high-interest rates as compared to banks and other formal financial institutions. Although both parties know it is unjust, however, lenders and borrowers both happily complete their transactions because of lower equity opportunity cost and quick process (Rasheed & Siddiqui, 2019). On the other hand, financial institutions do not show flexible behaviour to save SMEs from informal sector mistreatment. Despite the significant contribution towards country’s economy, SMEs only receive 6% to 7% of private sector financing. However, if compared with other countries, reports show that the SME sector in Bangladesh receives 25% of financing, 39% in Turkey and 18% in Sri Lanka and India. In addition, the report of Competition Commission Pakistan (CCP, 2023), concluded that 93% of SMEs found it cumbersome to avail financing facilities from banks, and 80% had not availed bank financing. In 2008, bank lending to SMEs was 15% which declined over the years and reached 7.3% in 2023.

Table 1: SME Financing Profile of Banks and DFIs (PKR in billion)

<table>
<thead>
<tr>
<th>Category</th>
<th>Sep-21</th>
<th>Jun-22</th>
<th>Sep-22</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of SME Borrowers</td>
<td>163,629</td>
<td>168,750</td>
<td>160,736</td>
</tr>
<tr>
<td>Domestic Private Sector Financing</td>
<td>7,247.56</td>
<td>8,438.21</td>
<td>8,527.74</td>
</tr>
<tr>
<td>SME Fin as %age of Domestic Pvt Sector Financing</td>
<td>6.04%</td>
<td>5.75%</td>
<td>5.40%</td>
</tr>
<tr>
<td>Outstanding SME Financing</td>
<td>437.71</td>
<td>484.81</td>
<td>460.21</td>
</tr>
<tr>
<td>SME NPLs Ratio</td>
<td>19.10%</td>
<td>16.52%</td>
<td>17.53%</td>
</tr>
</tbody>
</table>

Source: Competition Commission Pakistan (CCP), 2023

Table 1 depicts banks’ and DFIs performance of SME financing from September 2021-22. In spite of various initiatives taken by State Bank of Pakistan (SBP) to facilitate SMEs’ easy access to finance, financial institutions’ performance is not as desired. Instead of an increase in financing, data shows a clear decline from 6.04% to 5.4% in one year 2021 to 2022. Moreover, it's worrisome that SME borrowers also decreased from 163,629 to 160,736. The target set earlier by SBP for the year 2022 has not been achieved. The total number of 500,000 SME borrowers was expected, moreover, a 17% share of private sector financing was desired.

Figure 3: Share of Banks in SME Financing (PKR In Billions)

Source: Competition Commission Pakistan (CCP), 2023
Apart from this, commercial banks’ lending in 2023 was estimated PKR 519 billion, the lowest if compared with the demand of PKR 3.20-4.05 trillion.

Moreover, SME financing data presented by State Bank of Pakistan (SBP) in their quarterly report of June, 2023 depicts the decreasing trend in share of banks to SME finance. Moreover, Table 2 also shows that the number of SME borrowers also decreased as compared to last year. Facility-wise composition portrays that working capital financing stood at PKR 293 billion in June, 2022, however, reduced to PKR 275 billion, additionally, trading sector getting the maximum finance support as compared to manufacturing and services. As always domestic private banks are top of the list in the provision of finance, however, a major decline can be seen. Furthermore, commercial banks' support towards SMEs is not ample for sector growth and development and Islamic banks also not realize the potential of this sector through they can maximize their profits rapidly.
The inadequate financing of SMEs resulted in disequilibrium of SME credit market in Pakistan like other developing countries. This implies that both demand and supply side issues towards SMEs' access to finance prevent the sector from growing. Banks in Pakistan are hesitant to lend SMEs because they consider it as highly risky, as economic fluctuations impact these enterprises on a greater level. Furthermore, lack of collateral, creditors’ high search cost, lack of credible data on market size, high processing cost, etc also considered by the banks. These concerns show that banks are risk averse and reluctant to provide finance support to SMEs and on the other hand SMEs cannot afford to meet banking requirements and lengthy processes. The period of COVID-19 has already slowed down the economy, and the mismatch between demand and supply of the credit market of SME may worsen further signifying the need for intervention (SBP, 2023). This study addresses the issue of immense importance towards the development of SME sector in Pakistan. It focuses on the financial constraints that limit the growth of SMEs and prevent banks from extending finance to this sector. The main discussion under this study caters that inclusive finance is not possible without easy access of finance for SMEs from the formal sector. Moreover, this study aims to examine the supply-side factors that impact SMEs access to finance which ultimately leads to financial exclusion of SME sector in Pakistan.

Source: SBP, 2023
Literature Review

Peaking Order Theory

The outside funding and equity used by a company to finance its investment described by capital structure. Prior research proved the relevance of the pecking order theory with SMEs as it assumes that either internal or external, businesses have a hierarchy of financing sources. Transaction costs and asymmetric information are crucial components of pecking order theory. Moreover, adhering to this theory, businesses prefer debt over equity while selecting capital structure and financing decisions are based on knowledge asymmetry (Rathnasingha et al. 2019). Studies explained that businesses always choose external finance when they realize they have insufficient internal funds. Thus, ensuring a safe and hurdle-free external finance endowment is important for the development of the business sector (Thathsarani, 2023). The current study has applied the pecking order theory because of its relevance as the study highlights the determinants constraining access to external finance for SMEs in Pakistan as these small and medium firms do not have enough internal funds and equity to use for growth and development. The scarcity of internal financing compels them to choose informal external finance which is easily accessible as compared to formal external finance. Moreover, it can be said that these firms follow the hierarchy of financing options and choose debt over equity when require external financing. Furthermore, the requirements of finance and information asymmetry are based on the size of the firm and the growth stage as well. However, SMEs in Pakistan face severe issues in accessing external finance because of several reasons such as; lack of collateral, non-availability of credible data, lack of professionalism and perceived risk.

![Conceptual Framework](image)

The conceptual framework of current study highlights the supply-side factors that impact SMEs access to finance in Pakistan. Various studies in developing countries examined the influence of numerous demand, firm and behavioural factors on SMEs access to finance, however, supply-side factors only discussed briefly. The following hypothesis proposed by the study to test the significance of supply side factors on SMEs access to finance.

**Proposed H1:** Collateral requirement significantly impact SMEs access to finance
**Proposed H2:** Higher costs significantly impact SMEs access to finance
**Proposed H3:** Complex and lengthy process significantly impact SMEs access to finance
**Proposed H4:** Complexity of financial products significantly impacts SMEs access to finance
**Proposed H5:** Lack of trained staff significantly impacts SMEs access to finance
SMEs serve the world economy as a large innovative catalyst as provide support through a substantial share in job creation and poverty reduction (Manzoor et al. 2019). Several studies provided empirical evidence on the relationship between SMEs and poverty alleviation, moreover, research reinforces the fact that the financial development of SMEs is crucial to eliminating poverty from the list of hindering emerging economies from growing (Edom, Inah, and Emori , 2015; Kowo, Adenuga, and Sabitu, 2019).

SMEs access to finance is the main concern for experts and researchers in the development of this sector. Additionally, in developing countries, policymakers' main agenda for economic boost is the financial inclusion of these small and medium firms. Prior research explored several challenges and obstacles SMEs experience in getting external finance. Financial institutes including banks do not consider the financial requirements of small and medium firms seriously at different stages and levels of development, particularly ignoring the needs of start-ups and young firms (Raza et al., 2018). Thus, most of the time these businesses adapt equity type financial instruments to fulfil their financing needs. Studies discussed that external factors have a greater impact on SMEs growth such as monetary policy caused by a reduction in SMEs net worth as well as the closure of 7 percent of sampled firms. Generally, in developed economies, SMEs receive maximum support from institutes to flourish. On the other hand, in developing economies, small and medium businesses mostly rely on informal setups and get affected by multiple market failures and lack of sustenance from formal institutes. Family and friends play an important role in the development of SMEs by providing financial care, particularly in the initial stage (Ndiaye, Razak, Nagayev & Ng, 2018; Herr & Nettekoven, 2018). These small businesses establish private governance systems for strong and long-lasting associations, ethnically-based, business networks for entrepreneurs. The access to finance through these networks varies according to ethnicity, for instance, in East and West Africa entrepreneurs form business networks help them in lending by providing personal references and guarantees. It eases informal transactions through the mechanism of reputation-based contract enforcement. These networks of connections help SMEs in overcoming the obstacles of weak formal systems of contract enforcement and asymmetric distribution of information. The existence of these networks in Pakistan too is a blessing for small and medium firms evidenced by research (Desalegn, 2021). Moreover, strong social bonding in the region where family, friends and referrals extend their support beyond the limits nurtures the sector on a larger scale (Rasheed et al., 2016). In developing economies, SMEs faced issues and challenges are abundant, such as scarcity of financial sources, incapable labor force, unskilled administration, adoption of technology, poor infrastructure, traditional and manual methods of manufacturing etc. (Soomro, Shah and Mangi, 2019). Bekele, (2022), examined that from supply side high bank charges and lower levels of confidence in banks, significantly influence the financial inclusion of SMEs. Similarly, on-demand side working capital requirement, technology, expansion of business and funds availability are positively associated with financial inclusion.

National financial inclusion strategy of State Bank of Pakistan (SBP) states that formal financial sector fails to meet small and medium firms' financial needs on a larger scale. Firms use their own resources for working capital and investment needs. It is worth noting that despite high demand banks extend financial support to SMEs on limited basis and it’s a major concern for the policymakers in Pakistan. According to NFIS report, (2015) weakness in contract enforcement, legal frameworks, electronic movable collateral registry, lack of knowledge, lesser use of other financial alternatives and SMEs limited business capacity are the major constraints to SME finance. Moreover, informal setup, weak financial statements, and lower HR capacity of SMEs make banks hesitant to help these firms towards easy access of finance. Furthermore, banks lack in differentiation between medium and small firms and have same thresholds for micro, small and medium firms. The Competition Commission of Pakistan (CCP) report, (2023) discussed that Pakistan lacks in specialized financial institutions in SME financing and a committed banking
network for SMEs. Moreover, trained staff to serve SMEs also essential as the requirements of an individual and corporate sector both are altogether different from SMEs.

Critics argue that SMEs should focus on wider financing sources and that only access to finance is not the sole reason behind the slower growth of SMEs. Studies explored that various other factors related to the demand, supply, firm, and behaviour of SME owner-managers influence the development of these firms. A study by Rasheed et al. (2016) explored that behavioral factors of SMEs owner-managers impact their financing decisions too. In context of Pakistan, the study concluded that because of religious and social factors, SMEs show adverse behavior toward the adoption of formal finance. Pakistan has around 240 million adherents of Islam and a large population of SMEs consider formal finance prohibited in Islam because of interest (Riba). However, it’s a greater opportunity for Islamic banks to reap the profit from this major sector by providing them with financial support according to Islamic rules and laws of Shariah (Rasheed and Siddiqui, 2019). A study in context of Bangladesh concluded that gender and characteristics of owner-managers significantly contribute towards the success of a business, however, found insignificant impact of firm characteristics. Studies also explored that in Pakistan small and medium firms lack strategic planning which impedes the sector growth.

Furthermore, studies also emphasized on the availability of trained staff in banks and other financing providers to SMEs. The lower level of awareness among SMEs regarding financial products creates hindrances in their financial decision-making. Experts revealed that most of the SMEs feel reluctant while applying for formal funding because of complex financial products, incomplete information, product as per their financial need and higher transaction costs majorly influence their financial plans. Furthermore, SMEs interested in Islamic financial products have limited options, however, the complexity of both Islamic and commercial products can be measured as the same (Khan, 2015). In addition, SMEs choose informal financing options because of short and convenient processes and procedures. On the other side, bank processes are much longer and less convenient because of complex documentation, time frame and security assurance through guarantees of some existing bank customers or any large firm owner-manager and collateral. Small and young firms most of the time fail to fulfill all the requirements of financial institutes and because of small and informal infrastructures, banks normally reject applications. Thus, SMEs consider informal financing options more convenient, hassle-free, lesser cost and fast process. However, financial institutes no doubt lose a bigger chunk of profits because of underdeveloped legal and financial infrastructure and restrictive policies and procedures.

**Methodology**

Experts explained that quantitative research entails theory experimentation by creating and empirically examining research hypotheses. Quantitative methods employ numerical data to address research questions related to the study's nature and context. Therefore, the choice of methodology and design depends on research problem, nature, and scope of the study (Creswell, 2009). Given the nature and scope of current study is in line with the quantitative method to address research questions adequately. Therefore, to examine the problem of SME’s access to finance from supply-side perspective, quantitative method approach has been deemed to be most appropriate.

**Research Design and Framework**

To answer the research questions of study, the planning of data collection, measurement, and data analysis known as research design. Experts discussed that each point of research design presents various critical points; therefore, not any single design is appropriate in all situations. Thus, researchers have to choose the most suitable as per the requirements of study. The research quality completely depends on the choice of proper design by considering the study research
questions, objectives and limitations. Additionally, along with the selection of research design, other choices related to data collection method, sample design, measurement of variables, data analysis tools, and techniques need to be finalized (Bougie and Sekaran, 2019).

Causal research design is the most appropriate one to examine the impact of independent variables on dependent variables, thus, the current research applied causal design to examine the impact of various supply-side factors (collateral requirements, higher cost, complex and lengthy process, complex financial products and trained staff) on SMEs access to finance in Pakistan. Researchers defined causal research as explanatory which identifies the cause-and-effect relationship of variables. To explore the cause-and-effect relationship two methods practiced by researchers in their studies; statistical research and experimental. The experimental method is appropriate for those who conduct their research in laboratories by conducting various experiments, however, the other method experts suggested is suitable for research related to social science, economics, and business (Kothari, 2004).

Furthermore, the study population consists of owner-managers of SMEs registered and operational in the province of Punjab Pakistan. Approximately, 3.2 million of Micro, Small and Medium Enterprises are currently operational in Pakistan. Around 65% are registered under the province of Punjab, 17% in Sindh, 14% KPK, and 2% exist in the province of Balochistan, Pakistan. Moreover, according to the population, five major cities have been selected to collect data from the Punjab province as Table 3 depicts the details.

<table>
<thead>
<tr>
<th>Sr. No</th>
<th>City</th>
<th>Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Lahore</td>
<td>11,119,985</td>
</tr>
<tr>
<td>2</td>
<td>Faisalabad</td>
<td>3,210,158</td>
</tr>
<tr>
<td>3</td>
<td>Rawalpindi</td>
<td>2,097,824</td>
</tr>
<tr>
<td>4</td>
<td>Gujranwala</td>
<td>2,028,421</td>
</tr>
<tr>
<td>5</td>
<td>Multan</td>
<td>1,872,641</td>
</tr>
</tbody>
</table>

Furthermore, SMEs data have been collected from the Chamber of Commerce of all major cities and by using the stratified sampling technique strata have been defined as per the nature of small and medium firms. The study has included three major sectors in the population; manufacturing, service and trading. In addition, to meet the research objectives and to know the magnitude of the problem, study has used the cross-sectional design. As Cavana et al. (2001) stated under this design the data can be collected in one time which is quicker and more cost-effective. However, in longitudinal design researcher evaluates the population at regular intervals and observes the variations. For data analysis, the PLS-SEM technique has been selected by using the latest SMART PLS 4.0 software.

**Conclusion**

Current study has presented a conceptual framework, an effort to explore the constraints towards inclusive finance for SMEs in Pakistan. Study mainly focused on supply-side factors impact SME’s financial decision-making. Experts and policymakers explained how inclusive finance for SMEs can develop the sector as well as boost the country’s economy. Despite various government initiatives the sector still suffering from lack of finance and bound to use informal
finance. Furthermore, extensive research has discussed and revealed various demand, supply, firm and behavioral factors that influenced SMEs access to formal finance. Studies highlighted that firm size, characteristics, owner-manager social and religious beliefs, awareness, higher cost, lack of knowledge and misalignment between SMEs needs and available financial products and services hinder the inclusive finance target for SMEs. However, limited research examined the impact of supply-side factors on SME’s access to finance. To fill in the gap study has currently proposed the research framework based on secondary data, however, in the next phase data analysis will be completed. Study will highlight the significance of factors impacting SMEs access to finance in Pakistan.

References


