Obstacles to Small and Medium Enterprise Development

There exists a fatal gap in our approach to promoting the free market economy in Bangladesh. The gap is our lack of emphasis on promoting small and medium enterprises (SMEs). Given the level of our capital accumulation and the size of our market, it will be the SMEs which, given a chance, can play a crucial role in promoting the growth of our market-based economy.

It is our considered view that a concerted effort needs to be made to promote SMEs in Bangladesh. To examine the obstacles being faced by the SMEs, The Daily Star organised a roundtable on the subject, bringing together all the relevant actors in the field to discuss ways to overcome them.

Our roundtable was organised in collaboration with the JOBS' Programme of USAID which is specially designed to promote SMEs. It is our hope that government policy makers will take serious note of the suggestions put forward below and create the right policy environment for the rapid growth of SMEs in Bangladesh.

Mahfuz Anam: I welcome you to this round table. This initiative comes from a very strong conviction out of The Daily Star that SME development in Bangladesh is very important if not crucial part of the development process that has not received the type of attention, the type of policy support that it needs and deserves. Through these discussions we will be able to bring these issues up on a public domain and attract the attention of the policy makers and The Daily Star specially will try and play some advocacy role on the policy directives, the steps that need to be taken which will hopefully emerge from the meeting. We want to focus on two particular areas of the SME development. One is access to credit, the other is highlighting what we call the absence of a level playing field for the SMEs.

Access to credit, I suppose, is self-explanatory and about the level playing field, what we are looking at is the discriminatory type of VAT or taxation process, issues like high rates of utilities and disadvantaged our tariff structure. We have a variety of participants coming from various fields – academia, administration, banking, government; and we hope that we will have a very lively and stimulating discussion.

I start the session by inviting Dr. Zia Ahmed, the team leader of the JOBS program, to give the welcome speech.

Dr. Zia U. Ahmed: We hope this discussion will facilitate that process of increasing awareness among the policy makers as well as the practitioners in the process of growth of small enterprises in Bangladesh and ultimately increase employment and income for the poor people of Bangladesh.

Mahfuz Anam: The way this discussion is structured, we begin with three background presentations:

1. Secured Finance by Mr. Allen Welsh
   Credit Information Bureau by Mr. Forrest Cookson
   VAT and tariff related issues by Dr. Zahid Bakht.

Allen Welsh: In developed economies, movable property is as good a collateral to secure repayment of an obligation as immovable property. The equipment of a manufacturing plant, the inventory of a dealership, the accounts receivables of a company, are as good collateral as land. I say that this is the case in developed economies. But it will be more precise to say that the economies are developed because this is the case. It's because these kinds of collateral are such powerful economic development tools under that law that the economies have developed very quickly in the last part of the 20th century. In the last part of the 20th century, the legal framework for the use of movable property as collateral was very similar to what is here in Bangladesh today. You have provisions in the law, for example for pledge, for conditional sale, for financial lease, for floating charge, and there are other examples for the use of movable property as collateral. You have registration of charges, in the event the debtor is a joint stock company. These are examples of how movable property can be used under current Bangladesh law, and we might ask the question, why are not these techniques more effective than they are.

I will make four brief points about a modern secured financing system based on movable property as collateral:

It should be very simple, very cheap and very quick to create a security interest or a property right in the movable collateral. No more than a simple contract between the creditor and the debtor should be required to create property right in the accounts receivable, in the equipment, in the inventory. Compare that with the current law, we have various forms of transactions and each has its own procedural rules under the law. This makes transaction costs very high and it makes the outcome unclear. By creating a simple single set of rules, it is possible to greatly reduce the costs of creating an interest in movable collateral.

It is crucial that prospective creditors be warned of the possible prior existence of a lien or charge of the movable property; for example, if you lend money to me, and I pledge to you my manufacturing equipment as collateral, you will want to know if I did not yesterday pledge the same equipment to another creditor. You will want to know for sure that your interest is first and no second or third. Under current Bangladesh law, this may be possible only if the debtor is a joint stock company, and only for certain kinds of collateral. It is very important that a there be a system of registry, which includes all interests in all kinds of movable property for all debtors. That way any prospective creditor can go to one place with respect to any debtor and determine whether there is a prior interest in the one that is being offered. This is the second reform that can be very powerful in extending or expanding access to credit, because it makes creditor more secured in giving the loan.

Reforms in the primary rules that apply to the creditor who holds an interest in the collateral. For example, if I borrow money from you, and I pledge my manufacturing equipment as collateral, you will go to the notice system. If you find no notice in the registry covering me as a debtor with respect to equipment, you will assume that your interest is the first in line. If there should be dispute between you and third party who is not a party to our contract – but that may not always be the case, further disputes may come up. For example, let's suppose that after the loan is made, I fail to pay my taxes. The tax authority may win a judgement which entitles it to come to my place of business with an order to take away my movable property, and that movable property is your collateral. So at the time we made our contract, you believed you were the first, now the tax authority claims that it is the first. It is very important for the creditor to know that if there is a default he will get the collateral. If other interest groups jump ahead of the creditor, then it will diminish the security of the collateral and it will diminish the likelihood


Allen Welsh

that you will even give me the loan in he first place. There other examples of third parties who may come into play, e.g. may be I have a contract also with Dr. Zia. I breach the contract with him, and he wins the judgement against me, and the judgement entitles him to come to my place of business, take my movable property, and that movable property happens to be your collateral. Or I may go bankrupt and the bankruptcy trustee may attain the interest in my movable property. Under the new bankruptcy law in Bangladesh, the secured creditor has better rights than before but having studied the law, I think we may be able to identify possible ways to improve the creditor's security even in a bankruptcy situation. So we must always look at what kind of parties may gain an interest in the collateral that might defeat the creditor's interest, and then we have to ask ourselves the question, does this promote commerce? Does this promote credit? I suggest that as you look at all the possible people that may intercede, and if you look at the problems associated with not being able to go to a registry and determine if there is a prior interest, these pile up and cumulatively they create a great barrier to credit.

Problems in respect to the enforcement of security interests. What happens when the debtor does not pay? Under Bangladesh law today, the primary enforcement mechanism is a judicial mechanism in which we try to affect a judicial sale of the asset / collateral. The problem of course is that judicial sales are always very expensive and they take a long time, and the outcome is never certain. This again adds another barrier to the credit situation. What kind of legal reform can address the issue under modern secured financing law? The first recourse is an attempt to work with the debtor to recover the collateral without judicial action. But it is not currently in many civil law countries, and is not possible under Bangladesh law. Today the creditor would most probably like recover the assets without the intercedence from the judiciary. If that's not possible, then an expeditious, low cost and certain hearing should be held in order o put the collateral into the hands of the creditor. If that doesn't work then a law suit against the debtor resulting in an order to move the collateral from the debtor to the creditor is the next best alternative, and the last resort should be the current option, and that is judicial sale of the current assets with auctions. If the creditor has legal options that are sure, cheap and expeditious, that will serve to motivate the debtor to be more co-operative, may be it will not be necessary to recover the collateral, may be the loan can be reorganized. May be the debtor will cooperate in some kind of workout situation that will be satisfactory to both parties in the default situation. May be we can save the debtor from going bankrupt, and out of business.

These four ideas can become much more valuable in Bangladesh society.

F.E. Cookson: I want to discuss very briefly the problems related to credit information. One of the essential components of taking credit decision by a financial institution is information on the background of the company and the repayment record of the company in prior financial commitments. In Bangladesh there is a part of the Central Bank called the Credit Information Bureau. It was established several years ago and it provides information to other banks and financial institutions with respect to their potential clients. But it provides information only on the enterprises whose total facilities is greater than one million taka.

We can see a little further the problem. Right now the CIB handles somewhere between 200 and 250 requests for information a day. That is about 40 or 45000a year. The number of enterprises in the manufacturing sector with ten employees and above is somewhere between 20 and 30,000. And when you add in all the trading establishments and other kinds of businesses, then you can see that the number of loan applications is really focused on the higher end of the economic size spectrum. More seriously, if you are focused on trying to provide credit information on small and medium enterprises, then you are probably talking about increasing the size of your database and you operations by a factor of ten. The implication of that may be quite severe.

The CIB collects information regularly from the banks for loans. For facilities extended between 1 and 10 million, this information comes every quarter. The requests dealing with the information, on the average, are two months late. For exposures, which are more than 1 million taka, the data is reported monthly, so the delay is 2 to 3 weeks.

When the name of the enterprise is before the CIB, it tries to establish whether that enterprise is already in its database. If it is certain that it has the name, address and other identi-


Forrest E. Cookson

fying information correct, and this enterprise is not listed in its database, then it indicates that there is no loan outstanding. If however they do find that the enterprise is listed in their database, they will prepare a report which lists all the credit facilities that that enterprise has available to it. It does not tell the clearing bank who has made this loan. It is explicitly forbidden by law to do so. So the recipient bank knows the condition but it does not know which bank had made these loans.

CIB also takes the list of directors. For each director they then consult their owners' database. And in the owners' database there will show up every enterprise in which that particular person is a director. So, the CIB can provide the information to the requesting bank regarding the loan status of every organization owned by the directors of the original organization.

This system, although working quite well, is not dealing with the SME problem at all. Although some medium enterprise will become engaged in this, small enterprises will not. Furthermore we know from the numerous studies on the small enterprise sector that (in my judgement) considerably less than half of the small enterprises have access to bank credit at all. But all have access to trade credit and records of performance of these trade credits are not available at the CIB.

I have tried to estimate what it costs the Bangladesh Bank to provide these reports, and my estimate is that it costs about 200 taka for each of the reports, given the staff and the typical overhead of the Central Bank. 200 taka is actually a tiny little amount compared to the size of the loans (on average 2 to 5 million taka or larger). However once you begin to consider the small and medium enterprises, the magnitude of the database will go up by a factor of 10, and the average size of the loans will be declining rapidly. So, the cost of the credit information becomes a much more serious concern.

The particular proposal that we would like to discuss today is to shift the CIB out of the Central Bank and into the hands of someone else. There should be discussion on who is this someone else. If the objective is to extend the credit system so those working with small enterprises can use it, then it is really essential to change the ownership of CIB. I do not think the Central Bank is interested or very soon will be prepared to increase its database by a factor of 10 and incur the cost and the considerable data management problems that will follow. And I also do not think that the management efficiency of the Central Bank will increase up to that level.

It has long been the aspiration of the people of the financial sector to broaden the information that is provided to include something resembling a credit rating. But the Central Bank should not be making credit ratings for private enterprises. That is an extension of their power which is dangerous for them as well as the banking system. So the ability and willingness to make judgements about credits must be shifted to others' hands.

So for these reasons, there is a strong case for shifting this function out of the Central Bank. In the discussion I have suggested four things that you may wish to comment on:

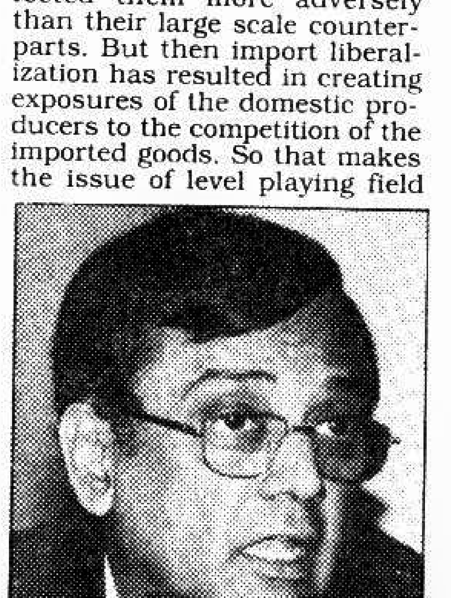
First, is it correct to move this function out of the Central Bank to the private sector.

The second is the issue of secrecy of this information, where the legislation is required to enable private organizations to provide credit information.

Third is, how does one see the industry of credit information. Will this be a monopoly, as it is now, or should it be open? The normal proposal here is that this should be an organization owned by the financial institutions. But there's considerable doubt that any one can make this work, and that is worth discussion.

The last point is whether the reporting procedure that I described for the CIB, namely looking into the credit records of the directors in their other enterprises, how that information should be interpreted or used.

Dr. Zaid Bakht: There have been substantial reforms in the external trade policies of Bangladesh during the past decade. Import procedures have greatly eased, duty rates have been slashed and quantitative restrictions have been virtually eliminated. This has greatly eased the access of the producers to the import of raw materials and have particularly benefited the SMEs, because in the earlier dispensation they were the ones who had to suffer most in terms of not having import licenses, exchange controls etc., and all of these affected them more adversely than their large scale counterparts. But then import liberalization has resulted in creating exposures of the domestic producers to the competition of the imported goods. So that makes the issue of level playing field


Zaid Bakht

in terms of the policy concerns such as tariff structures, indirect taxes such as VAT, utility rates...it makes them all much more relevant today than ever before. So in this context I'll formulate the key issues in the form of the following questions:

Do the existing duties and taxes add substantially to the input costs of the SMEs? Is there an adequate gap between the duty of inputs and that of on the finished goods? Whether or not the existing indirect taxes, particularly the VAT, push the SMEs in a relatively disadvantaged position; the issue of the utility rates and whether or not there is a case of preferential utility rates for the SMEs? We have collected information on three SME subsectors which were earlier studied by JOBS. And these are electrical goods, bakery and footwear.

More than 90% of the inputs used in the electrical goods sub-sector are imported. Some of the tax rates for them are as high as 40%. And I have worked out an unweighted average here to that you are supposed to add the licence fee, which is over 2.5 %, then the AIT, another 2.5%, and the recently included infrastructure of 2.5% which together is and 7.5%. And then you have the VAT which is charged on the duty paid value, which is 15%. The aggregate value of the taxes is around 55%. Whether that is high or not is subject to discussion.

Bakery products also use quite a bit of imported raw materials. Once again I have worked out the unweighted average for this industry which comes to 65%.

In the small scale footwear, there are three major components: the leather footwear, the plastic footwear, and the rubber footwear, which has to do with the input cost of EVA which is the foam type of thing used in producing rubber sandals and other things. And on EVA there is this 30% customs duty, which if you add up with other things will come up to 50% of aggregate tax.

The cost of inputs are going up by an excess of 50% due to all these taxes. The actual rate may be even higher if you take into consideration the tariff values, the value that is assigned in the absence of correct invoice prices, and very often the producers complain that this is in total misalign with the real situation, and therefore the importers importing goods from cheaper sources end up paying higher duties because of the higher tariff values and so the actual tariff rate in that case becomes even higher.

Now if we look at the finished goods situation, then we can make a comparison in terms of whether or not the gap is enough, and whether or not there is need for further tariff rationalization. I've been able to put the duty rates for the items: the different components of electrical goods, and the imported biscuits. The aggregate duty rates here are from 58 to 70%, which of course is slightly higher than the duty rates we have just looked at in the case of inputs, but two observations, first, is the gap sufficiently large to be able to retain the competitive edge of the domestic SMEs. And second, given the widespread smuggling, even this slightly higher rate may not be effective in reality.

First, The duty rates on inputs do seem to be of a magnitude which calls for downward revision if we want to make SMEs more competitive.

Second, in terms of the gap between duties on finished goods and imported inputs, the existing gaps do not seem to be sufficiently high to keep the SMEs sufficiently competitive specially vis-à-vis the large counterparts and the legal and illegal imports from other countries. Now, moving on to VAT, as you know the going rate is 15 %, and the exemption level that has been granted to the SMEs is a turnover of 15 lac per year. The SME producers object to this on several grounds. Firstly, they are saying in the neighbouring countries the rates are much lower, and given the long and very porous border it's; very relevant for us. So that cuts on our competitiveness vis-à-vis those goods. Secondly, they say that this cut-off of 15 lac is not high enough to accommodate most of the SMEs.

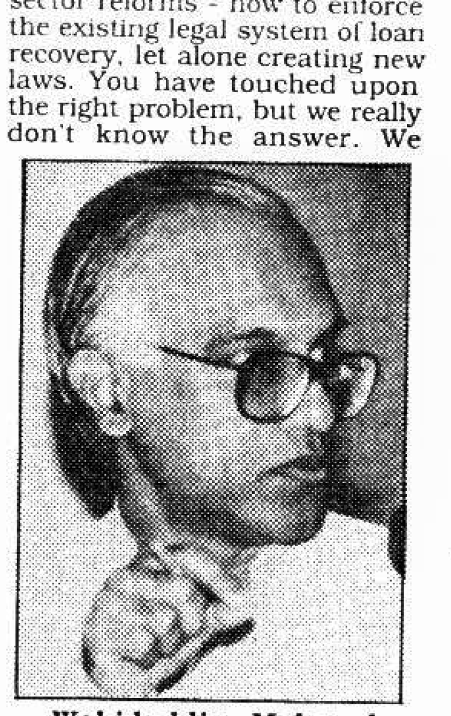
And the third is that very often the SMEs, particularly the lower part of the chain, have to deal with very informal traders where they make very small procurements and therefore the process doesn't involve the type of documentation which is required if they have to get the full benefit out of the adjustments.

The other point they make is that they have to go for credit sales. Given their serious liquidity problems to clear their VAT claims as soon as they produce they send the goods out of the factory. But then the NBR people are waiting to harass them and confiscate their goods because of non-payment of VAT and they are in no position to produce the documents that they have paid the VAT. So the suggestion here is if we really want to promote SMEs that then first of all lets find out whether or not that 15 lac limit is the right limit. I would tend to agree that perhaps the ceiling needs to be increased. This is something on which information can be collected fairly quickly and decision can be taken in a much more informed way.

I think the smuggling aspect is a fact of life. There was this perception that the overall trade liberalization is going to reduce the level of smuggling because smuggling takes place only where the tariff rates are high. But then we have the funny situation where that you go for trade liberalization and the smuggling increases. What is the mystery? Even after you reduce the tariff rates the margin is still sufficiently high and acts as incentive for smuggling. It may work the other way round in the sense that now you have already legalized imports, one can easily be tempted for illegal imports given all the hassles one has to go through for legal imports.

So I would say that both in terms of cut-off level and displacement threat from smuggling, one needs to reconsider this issue of VAT. Finally, about the issue of utility rates, the SMEs are claiming that there is a case of differentiated rate for them, to be able to able to retain the competitive threat vis-à-vis the large counterparts. The question is, to be able to handle this issue, one needs to find out whether or not there is a differentiated pattern in the use of the utilities. If the answer is no, then you are addressing a particular sickness with the wrong type of medicine. If the differentiated rate of utilities is not the cause behind the differentiated performance, then a differentiated utility rate is not going to bring efficient utilization of resources. On the contrary, it may induce the large scale industries to abuse that.

Dr. Wahiduddin Mahmud: *On Allen Welsh*.....about non-judicial settlement...of course that is not desirable. But when it comes to judicial settlement it is rightly pointed out that we need cheap expeditious judicial process. That is our entire problem now with the financial sector reforms - how to enforce the existing legal system of loan recovery, let alone creating new laws. You have touched upon the right problem, but we really don't know the answer. We


Wahiduddin Mahmud

know we have to do something about it.

On Forrest Cookson ..... credit information..... whether any trade organization could do this function. Well I don't know. There has to be legal provision that they should have access to the bank information. That cannot be then regulatory but can be a promotional thing.

On Zaid Bakht ....this is a well involved issue. There is a need for assessment after we have done all the tax reforms. You have put some indicative figures, but we really want to know what has happened to the effective protection rate to small scale and large scale industries. Your figures show that the duty paid on inputs are almost equal to those of finished products. Of course here we should, as economists, point out things one if there is any misconception — if there is 50% duty on inputs and 50% protection and duty on finished goods then the equality of these rates does not mean that effective protection, that is protection on value added, is zero. It means there is 50% protection also on value added. This is something that all economists know but sometimes it's ignored and industrial lobbies sometimes (I don't know if deliberately or not) ignore this issue and demand that there should be a difference between these two rates. But given that you need to give the protection, you need to assess it first and then choose what should be the rational protection.

But your figures point out something more important: in the last discussion on JOBS project you said that you want to promote small scale industries for being export oriented. There I think is a major problem. If you pay duties on inputs of up to 50 or 60% and if you do not get drawback facilities or bonded out warehouse facilities then there is no chance that small scale industries can be competitive in the world market. This is a problem...I mean when import liberalization is incomplete and inputs have to be taxed at least for revenue purposes, then how do we make indirect exporters and small producers competitive in the world market. There is an administrative problem of giving duty drawback facilities to small producers because of the problem of keeping records and so on. And how to cover indirect exporters who give inputs for the exporters... One way around is to announce a flat cash incentive for any direct or indirect exporter on the basis of some calculations on what they pay as duties. At the moment we do this only for cloth — domestic cloth production which is used in the RMGs or are directly exported. My proposal is that not only for cloth, but why don't we go for broad group of prospective export items and we announce a rate of cash incentive, by calculating a rough estimate of what could be the reasonable compensation for the duties they pay.

This has to be an across the board rate because otherwise it cannot be administered. Some have argued that this will create a burden on the exchequer. But my argument is that these are prospective exports. If this incentive does not bring the new exports, then you don't have to lose anything because you don't have to pay anything. But if it is really successful and there are new exports from SMEs and other sectors then this is a cost which is worth incurring. I think it should be our policy priority if we want to go for export oriented industries.

The growth of small scale industries is very shaky. In the case of small scale industries, the rate of entry is quite high, but the rate of exit is also quite high even in spite of the net increase in the number of enterprises and production. This high rate of deaths of small firms shows that for small firms the Bangladeshi environment is a risky environment. We should investigate where those risks come from if we want to remedy the constraints for SMEs. The constraints come from access to credit, access to utilities, and the problem of governance. Problem of governance creates the problem of transaction costs: transactions costs involving access to credit, access to electricity, transaction costs of bribery in dealing with the VAT officials etc. And that is why in spite of market oriented liberalization process I think that the playing field is not level, at least if not for anything at least for governance.

Last of all in this governance issue is the phenomenon of illegal toll collection and extortion of money under political patronage throughout the country. Again I think the cost of this is borne unevenly by small traders and small producers. This is a fundamental problem in the constraints to small scale entrepreneurship to free the market from toll collectors.

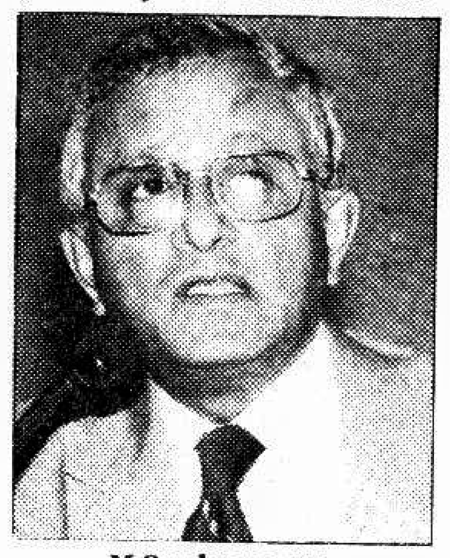
M. Syeduzzaman: To increase the share of industries in our GDP, particularly of manufacturing, is an important objective of government's current policies and structural adjustment programs. In Bangladesh the share of the manufacturing is lower than in many developing countries.

There are a number of constraints in expanding the large scale industries. Therefore small and medium enterprises is potentially a very suitable area for stimulating growth and it needs careful attention. Investigating their problem and attempting to create a conducive policy and support environment is therefore extremely important, and the JOBS program has taken a commendable initiative in this direction.

This is also a challenge because this falls in between the two extremes that we are experiencing in Bangladesh: one is this huge default in financing credit programs of large industries, and the other is the overwhelming success of the micro credit operations. Post flood issues confronting the SME sector identifies a number of issues that deserve attention, namely access to credit particularly in terms working capital, rationalization of tariff structure, reduction and elimination of tariff anomalies, increasing VAT exemption limits, and action on the rate on utilities so that they are at par with the large manufacturers. Regarding rationalization of tariff anomalies and the level playing field about rate of utilities, there can be no differences of opinion. But regarding the VAT exemption limit, I think a more convincing case needs to be made, as also referred to by Dr Wahiduddin Mahmud. But the major issue remains the availability and access to capital resources and credit. An important objective of the exercise therefore is to increase access to credit through strengthening of the use of movable poverty as security for loan.

Left to market forces, under the present regulatory and financial regimes, commercial banks and financial institutions have been extremely reluctant to come forward in these directions. The issues here clearly identified are those of, adequate and clear title to collateral, the prevailing legal system and problems to recovery, and also administrative cost of processing small loans. These problems have to addressed institutional arrangements rather than through quick fixes in the short term. The areas which in my opinion need attention are some upfront measures to prevent business failures and leading to willful default. The components here should be careful project preparation, project identification, and project preparation and project appraisal and arrangement of intensive supervision by the lending agencies. Important preconditions for these are training of loan officers and of entrepreneurs in several areas like market survey, project appraisal, cost benefit analysis, balance sheet analysis, cash flow analysis and profitability and loss account analysis.

Finally access to information regarding simple, efficient and modern technology. In the last several decades we have seen that attempts have been made to address the problems of small and medium industries. We know that a large number of industrial estates were set up, many of which are lying empty. There was a consortium arrangement some in the past between the BSCIC and commercial banks which we also know did not work. We also need to draw some lessons from the experience of the micro credit enterprise financing. It is not clear from the papers whether adequate examination has been made on the possibilities of the expansion of the small and medium enterprises through the NGOs under their present system. I think in this


M Syeduzzaman

context we should examine whether there should be ceiling for financing the NGOs beyond which financing could be taken over by commercial banks and other financial institutions. Regarding movable assets and using them as collateral for credit, even under the present arrangements movable assets are being used as security like equipment, inventory, consumer goods, documents, higher purchase, leasing arrangements, etc. some are used formally but some are used also informally like goodwill or salami. But these things take place mostly in transfer of assets rather than in current operations. Though the prevailing system of commercial banks authorizes acceptance of various types of securities, there are problems, regarding the protection of creditors' right, which is weak and hence their reluctance to enter this area. Transaction cost has been pointed out as being very high, and the creditors do not have the adequate level of comfort for entering this area. Financial innovations are taking place in other countries, particularly through controlling cash flows for issuing securities backed by mortgages, for credit cards issued by various banks, etc. What will be interesting to know is whether apart from industrial countries these were out in use in any other developing country. If there are some useful experiences then we could take lessons from those.

There are also some critical issues related to the financial sector reform for the SMEs particularly in the issue of interest rates. We have to accept and realize that the interest rate for SMEs have to be higher than for large industries. If we look at the latest Bangladesh Bank Annual Report, it shows that the range charged for small industries is anything between 9 and 12 %. But the volume of credit at this rate remained highly unsatisfactory. It's extremely unlikely that commercial banks will be willing to finance SMEs at these rates on a very large scale. From this two conclusions can be drawn; first, We need to arrange for public realization through active campaign about the inevitable increase in interest for SMEs if successive amounts of resources is to flow to this sector and this is necessary to avoid political backlash. Second, Government subsidized credit programs have to be gradually eliminated. These are not conducive to the growth of financing for SMEs at market rates.

A number of legal and administrative issues are also involved. These are establishing and enforcing priority claims of creditors, tax liability etc. Some of these issues are under consideration by the law reform commissions. Some are also under consideration under a proposed World Bank credit for standby and bridge financing for non-bank financing institutions. Some issues are also being considered by the Public Administration Reforms Commission.

The key issue is how can an incentive mechanism can be created for commercial banks

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