

# DEFINING MICRO, VERY SMALL & SMALL ENTERPRISES: MOVING TOWARDS A STANDARD DEFINITION-CONTINUUM

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By: Jaffar Jassim & Maham Khawar

## Introduction

There is a disconnect in segmenting the Microfinance and the SME market in Pakistan. Across the country, definitions vary by stakeholder and institutions and even with loan group. Micro individual loans are defined on basis of annual income, microenterprise loans on number of employees whereas Small and Medium Enterprises (SMEs) are defined based on turnover and assets. While access to finance is a major constraint for growth, the need to address financing concerns requires a more in-depth review of Micro, Small and Medium Enterprises (MSME) definitions to ensure the enterprises that are considered too big to avail microfinance and too risky or small for commercial finance are properly defined and differentiated from the 'Bottom of the Pyramid' (Micro) enterprises and 'small' and 'medium' enterprises for targeted policy intervention, thereby ensuring financing continuum.

This paper will discuss the need for harmonization in definitions across institutions and propose moving from SME segment to Micro, Very Small and Small Enterprise (MVSSE) segment which will include Micro, Very Small, and Small enterprises. Part 1 will discuss the different definitions used in Pakistan and around the world. Part 2 will discuss the current distribution of SME firms, current financing gap and the case for greater segmentation. Part 3 will discuss the proposed move from SME to MVSSE segment. Part 4 will discuss the need for definition harmonization and evaluate some of the major defining parameters that may be used, and Part 5 will provide concluding comments.

# ACRONYMS

APEC	Asia Pacific Economic Cooperation
EC	European Commission
GDP	Gross Domestic Product
GLP	Gross Loan Portfolio
GNI	Gross National Income
IFC	International Finance Corporation
MIGA	Multilateral Investment Guarantee Agency
MSME	Micro Small and Medium Enterprise
MVSSE	Micro, Very Small and Small Enterprise
NFIS	National Financial Inclusion Strategy
PPP	Purchasing Power Parity
SBP	State Bank of Pakistan
SECP	The Securities and Exchange Commission of Pakistan
SME	Small and Medium Enterprise
SMEDA	Small & Medium Enterprises Development Authority
UNIDO	United Nations Industrial Development Organization
VSE	Very Small Enterprises
WBG	World Bank Group

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## Part 1:

# Defining Individual Microfinance and MSMEs

## Defining Microfinance & Microloans in Pakistan

Microfinance is generally defined as the provision of financial services to low-income people. The Individual level micro-loan is provided to a 'poor' person, defined by State Bank of Pakistan (SBP) as "an individual who has meager means of subsistence but is involved in a livelihood activity and has an ability to repay debt from an annual income (net of business expenses) up to Rs. 500,000/-<sup>1</sup>." This income limit was revised in 2011 from Rs. 300,000/-. Meanwhile, Securities and Exchange Commission of Pakistan (SECP) sets this income limit at Rs. 600,000/-.<sup>2</sup>

## Defining MSMEs in Pakistan

As is the case for individuals, for microenterprises and SMEs too there is no single definition; at least five different definitions are currently in use, with the State Bank of Pakistan, Small and Medium Enterprises Development Authority (SMEDA), SECP, International Finance Corporation (IFC), Pakistan Bureau of Statistics all defining SMEs differently. While microenterprises are defined based on the number of employees (between 1 and 10 employees), for SMEs, there are different parameters which are used. The national SME policy, which was approved in 2007, defines SMEs as businesses with up to 250 employees, paid up capital of Rs. 25 million and an annual turnover of Rs. 250 million. The National SME policy has however not prevented other government and private institutes to use different parameters for defining the SME segment.

While there have been attempts to harmonize SME definitions, this has largely been unsuccessful. It is also important to note that there is no distinction made for micro enterprises within the SECP companies ordinance, the SMEDA policy nor the SBP prudential regulations for SMEs. However, micro enterprises are defined separately from the SME segment. Furthermore, the national SME policy does not make distinctions between micro, small and medium, it rather gives a defining criterion for the entire SME segment. Table 1 below lists down these defining parameters by different institutions in Pakistan.

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1 (State Bank of Pakistan, 2014)

2 (SECP, 2004)

**Table 1: MSME definitions in Pakistan by various institutions**

Enterprise Category	State Bank of Pakistan		SMEDA	SECP	IFC
	(Manufacturing & Services)	(Trading)			
Annual Income					
Individual	< \$ 4760		Not Defined	< \$ 5700	Not Defined
Micro	-	-	-	-	
Small	-	-	-	-	
Medium	-			-	-
Number of Employees					
Individual	-		Not Defined	-	Not Defined
Micro	1-9		Not Defined	1-10	1-9
Small	20 to 50		Up to 250	Up to 250	10-50
Medium	51-250	51-100		More than 250	50-300
Annual Turnover					
Individual	-		Not Defined	-	Not Defined
Micro	-		Not Defined	-	Less than \$100k
Small	< \$1.4m		Up to \$2.4m	≤\$2.4m	\$100k-\$ 3m
Medium	\$1.4m – \$7.6m			> \$ 2.4m	\$3m-\$15m
Paid up Capital					
Individual	-	-	Not Defined		Not Defined
Micro	-	-	Not Defined	-	Less than \$100k
Small	-	-	Up to \$240k	-	\$100k-\$ 3m
Medium	-	-		-	\$3m-\$15m
Credit Limits					
Individual	< \$ 1400		Limits Not Defined	< \$ 1900	Limits Not Defined
Micro	< \$ 4760			< \$ 4760	
Small	\$ 240k			Not Defined	
Medium	\$ 1.9m			Not Defined	

Source: (SECP, 2008) (SMEDA; Government of Pakistan, 2007) (State Bank of Pakistan, 2016) (State Bank of Pakistan, 2014), (SECP, 2004)

The main parameters used in defining SMEs are number of employees, annual turnover and paid up capital. The State Bank only considers number of employees and annual turnover in defining SMEs, with different thresholds for 'number of employees' within the manufacturing and services sector and the trading sector. Parameters and thresholds also vary by institution. For example, as per IFC's definition, the threshold for any two of the three parameters need to be met for an enterprise to be categorized as either micro, small or medium enterprise.

## Defining MSMEs Globally

As is the case for Pakistan, globally too there is no standard definition for MSMEs even among countries, banks and other institutions. Within the World Bank Group, the IFC and Multilateral Investment Guarantee Agency (MIGA) have different definitions for MSMEs.<sup>4</sup> The European Commission (EC), Multilateral Investment Guarantee Agency (MIGA), International Finance Corporation (IFC) Asia Pacific Economic Cooperation (APEC), and United Nations Industrial Development Organization (UNIDO) all have different threshold definitions of MSMEs; these are summarized in the table below.<sup>5</sup>

**Table 2: Institution Specific definition of MSMEs<sup>6</sup>**

Enterprise Category	EC	WBG/IFC/MIGA	APEC	UNIDO
Number of Employees				
Micro	1-9	1-9	1-4	Not specified
Small	10-50	10-50	5-19	
Medium	51-250	51-300	20-99	
Annual Turnover				
Micro	≤ \$3.5m	\$ 0-0.1m	-	Not specified
Small	\$ 2.3 m– \$ 11.5m	\$ 0.1m-3m	-	
Medium	\$ 11.5 m – \$ 58m	\$ 3m-15m	-	
Total Assets				
Micro	≤ \$2.3m	\$ 0-0.1m	-	Not specified
Small	\$ 2.3 m – \$ 11.5m	\$ 0.1m-3m	-	
Medium	\$ 11.5 m – \$ 58m	\$ 3m-15m	-	

Source: (USAID, 2007)

\*These institutions do not provide definitions for individual borrowers.

\*\* These institutions do not provide credit limits as they are not regulatory bodies.

As is the case with Pakistan, the three most commonly used parameters are number of employees, annual turnover and total assets. The European Commission, WBG, IFC and MIGA definitions require that enterprises meet the threshold for any two of the three parameters to be categorized as either micro, small or medium enterprise; however, the parameter thresholds are different for the various organizations. The Asia Pacific Economic Cooperation considers the number of employees only, UNIDO broadly defines MSMEs as ‘enterprises that are too small to achieve an optimal division of labor, and thus an internal specialization in their business operations.’<sup>7</sup> However, UNIDO advises that different qualitative and quantitative indicators are considered to differentiate MSMEs from larger enterprises.

4 (Yon & Evans, 2011)

5 (USAID, 2007)

6 Exchange Rate Used: 1 EUR: 1.17 USD (obtained from [www.xe.com](http://www.xe.com), on 2nd Nov, 2017)

7 (UNIDO, 1999)

The next table on the page presents an overview of the definitions used for categorizing micro, small and medium firms around other countries in developing world:

**Table 3: Country Specific Definition of MSMEs<sup>8</sup>**

Enterprise Category	India		China		S. Africa	Bangladesh	
	Manuf.	Services	Agri.	Manuf.		Services	Indus.
Annual Income							
Individual	\$1540 (Rural) \$2465 (Urban)		Varies by region		N/A	N/A	
Micro	-		-		-	-	
Small	-		-		-	-	
Medium	-		-		-	-	
Number of Employees							
Individual	-	-	-	-	-	-	-
Micro	-	-	-	< 20	< 10	0-15	16-30
Small	-	-	-	20 - 299	< 50	16-50	31-120
Medium	-	-	-	300 - 999	100 - 200	51-120	121-300
Annual Turnover							
Individual	-	-	-	-	-	-	-
Micro	-		< \$75k	< \$452k	< \$10k	-	-
Small	-		> \$75k	> \$452k	\$141k-\$1.8m	-	-
Medium	-		>\$750k	> \$45m	\$283k-\$3.5m	-	-
Total Assets							
Individual	-	-	-	-	-	-	-
Micro	< \$39k	< \$15.4k	-	-	< \$7k	< \$12k	\$12k-\$900k
Small	\$39k-\$770k	\$15.4k-\$308k	-	-	\$141k - \$318k	\$12k - \$240k	\$900k-\$1.8m
Medium	\$770k-\$1.5m	\$308k-\$770k	-	-	\$141k - \$1.3 m	\$240k-\$3.6m	\$1.8m - 6m
Credit Limits							
Individual	\$1540		Varies by location		-	\$600	
Micro	\$1540		Varies by location		\$7k	< \$30k	<\$120k
Small	\$770k		Range		-	< \$60k	<\$240k
Medium	\$1.5m		from \$1600 - \$4m		-	< \$6m	<\$9m

Source: (RESERVE BANK OF INDIA, 2015), (Reserve Bank of India, 2015), (Underhill Corporate Solutions (UCS), 2011), (BB updates SME terms, 2017), (DEPARTMENT OF TRADE AND INDUSTRY, 2015), (OECD, 2016)

<sup>8</sup> Exchange Rate Used (obtained from [www.xe.com](http://www.xe.com), on 2nd Nov, 2017):

1 USD: 65.1 INR  
1 USD: 83.35 BDT  
1 USD: 6.64 CNY  
1 USD: 14.36 ZAR

All these countries define MSMEs in a different manner. In India, the definitions are based on total investment in plant and machinery, while China uses number of employees and turnover as a defining criterion. India is included in the case study due to proximity and shared practices and culture. China is also included as it has a proven record in lifting people out of poverty and has emerged as a heavily regulated and alternative growth model to the western capitalistic economies. Meanwhile, South Africa is the opposite when it comes to regulation of SMEs as it has the most under-regulated SME sector. Finally, Bangladesh is chosen, as it is considered as a pioneer in advancing microfinance and the concept of cottage industries.

Presented below are case studies detailing the above definitions in each of the countries.

## Case Study: India

Indian SMEs employ close to 40% of India's workforce. SMEs contribute more than 45% of India's industrial output, 40% of the country's total exports and create 1.3 million jobs every year (Firstbiz, 2014).

Table 4: MSME definitions in India for manufacturing and services sectors

Enterprise category	Manufacturing Sector - Investment in Plant & Machinery
Micro	Does not exceed INR 25 lakh
Small	More than INR 25 lakh but does not exceed INR 5 crore
Medium	More than INR 5 crore but does not exceed 10 crores
Enterprise category	Services Sector - Investment in equipment
Micro	Does not exceed INR 10 lakh
Small	More than INR 10 lakh but does not exceed INR 2 crore
Medium	More than INR 2 crore but does not exceed 5 crores

Source: (Dr. P. M. Mathew, 2014)

India has faced a significant growth in its start-up segment, particularly of non-agricultural businesses, over the past decade; however, there is a lack of different, segregated policies addressing the needs of new firms on the basis of their respective sizes (Dr.P.M.Mathew, 2014). Furthermore, there is a dearth of policies that would ensure a level playing field for the MSME segment. Any definitions in place should serve the MSME sector and encourage its advancement and growth.



It should be noted that these definitions have not been revised since 2006. In this period, due to inflation, the costs of doing business have significantly risen, hence increasing the amount of investment required (Dr.P.M.Mathew, 2014). This calls for a review of the limits placed on investment, and also warrants evaluating the use of investment as a parameter for categorizing the firms.

Categorizing firms on the basis of their investment sizes is inefficient since firms are not always clear about the level of assets they have. Given the family-oriented nature of micro firms, it is also difficult for them to differentiate between investments undertaken for business from those undertaken for personal use. Furthermore, the patterns of India's industrial sector are also changing, with the relative importance of manufacturing and services industry having changed. This should be reflected in MSME definitions. Similarly, the parameter of employee size should also be critically evaluated as it also comes with certain limitations which will we discussed further on.

The Union Budget 2014 has outlined steps that would lead towards the growth of MSMEs in India. These steps include a labor market policy, a plan for establishing a system for the motivation and growth of start-ups. However, what is required also is a reevaluation of MSME size limits and defining parameters.

## Case Study: China

In China, MSMEs comprise 97% of all firms, accounting for 80% of urban employment, and for 60% of total GDP in 2013. Of the MSMEs, more than 94% were micro enterprises. More than 60% operate in the services sector (with 36.5% operating in wholesale, retail and catering; 10.2% in tenancy and business services; 2.5% in information transmission services; 2.5% in real estate industries; and 8.5% in other service industries). In addition to the services sector, more than 18% operate in manufacturing and processing, 5% in construction and 3.2% in agriculture related industries. (OECD, 2016) The table below classifies the SMEs by industry sub-division into 14 categories and requires that both the indicators, i.e. income in Chinese Yuan and the number of workers is met for classification in the SME category.

**Table 5: MSME definitions in China by industry sub sector**

Sector	SMEs		Medium Business		Small Business		Micro Business	
	No. of Workers	Operating income (RMB)	No. of Workers	Operating income (RMB)	No. of Workers	Operating income (RMB)	No. of Workers	Operating income (RMB)
Agriculture, Forestry, Animal husbandry & Fishery..	..	20m or less	..	5m or more	..	500k or more	..	500k or less
Manufacturing Industry	Less than 1000	400 m or less	300 or more	20m or more	20 or more	3m or more	Less than 20	3m or less
Construction Industry	..	800m or less	..	60m or more	..	50m or more	Less than 10	50m or less
Wholesale Businesses	Less than 200	400 m or less	20 or more	50m or more	5 or more	10m or more	Less than 5	10m or less
Retail Industry	Less than 300	200 m or less	50 or more	5m or more	10 or more	1m or more	Less than 10	1m or less
Transportation Industry	Less than 1000	300 m or more	300 or more	30m or more	20 or more	2m or more	Less than 20	2m or less
Warehousing Industry	Less than 200	300 m or less	100 or more	10m or more	20 or more	1m or more	Less than 20	1m or less
Postal Industry	Less than 1000	300 m or less	100 or more	10m or more	20 or more	1m or more	Less than 20	1m or less
Information Transmission Industry	Less than 2000	1b or less	100 or more	10m or more	10 or more	1m or more	Less than 10	1m or less

Source: (OECD, 2016)

## Case Study: South Africa

In South Africa, SMEs account for more than 90% of formalized businesses (SME ENTERPRISE, n.d.) and contribute 40% towards the country's GDP and 90% of new jobs created between 1998 and 2005 were in SMEs (Jones, 2016). In South Africa, the common term used to refer to SMEs is "SMME" "Small, medium and micro-enterprises". The SMMEs definitions are outlined in the table below:

**Table 7: MSME Definitions in South Africa**

Enterprise Category	Number of Employees	Annual Turnover (S A. Rand)	Gross Assets**
Medium	100 to 200*	R4m to R50m*	R2m to R18m*
Small	Fewer than 50	R2m to R25m*	R2m to R4.5m*
Very Small	10 to 20*	R200k to R500k*	R150k to R500k*
Micro	Fewer than 10	Less than R150k	Less than R100k

Source: (Underhill Corporate Solutions (UCS), 2011)

\*Depending on Industry

\*\* Excluding Fixed Property

The NSB Act further adds a category of survivalist enterprises to the SMME category. These survivalist enterprises generate income which is below the poverty line. Examples may include hawkers, vendors, subsistence farmers etc. However this is often categorized along with micro enterprises.

## Case Study: Bangladesh

SMEs in Bangladesh are classified by three major sub sectors: Service, Business and Industrial. SMEs account for 90% of all enterprises, employ up to 25% of the total labour force and 80% of industrial employment. SMEs contribute 25% to the GDP and between 75% and 80% in export earnings (Business Innovation Facility, 2012). The table below shows the different indicators considered while classifying firms to SMEs; firms must fulfill both the criteria of fixed assets and number of employees.

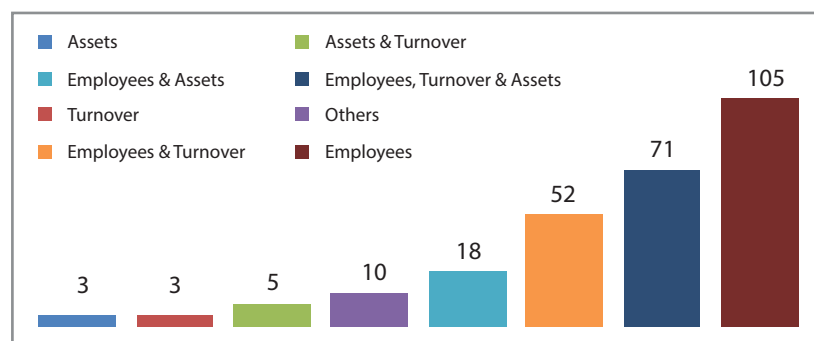
**Table 6: MSME Definition in Bangladesh by Industry Sub-Segment**

INDUSTRY SUB SECTOR			
	Service	Business	Industrial
Fixed Assets (Tk.)			
Micro	<1m	<1m	1m – 7.5m
Small	1m-20m	1m-20m	7.5m – 150m
Medium	20m – 300m	20m – 300m	150m – 500m
Number of employees			
Micro	0 – 15	0 - 15	16 - 30
Small	16 – 50	16 – 50	31 - 120
Medium	51 – 120	51 - 120	121 – 300

## Other Institutional Definitions used globally

Just as the case studies above show different countries defining SMEs based on various parameters, even within countries, institutions define SMEs differently. Recent MSME data collected by IFC for 155 countries conducted by IFC in 2014 reveals that there were 267 different institutional definitions, often different institutions within the country defining MSMEs differently. As the table below shows, the most common single indicator used for definition is the number of employees (39%) while 27% of the institutions use a measure of employees, turnover & assets combined and 20% use a measure of Employees and turnover only. Very few used only turnover or only assets in their definitions.<sup>9</sup>

**Figure 1: MSME Parameter - Defining Combinations Around the World**



Source: (Gonzales, Hommes, & Mirmulstein, 2014)

## Need for Standard Definitions

Definition standardization and better segmentation will provide access to finance to the financially excluded enterprises and have a more robust framework to ensure effective policy implementation. This will have benefits at both micro and macro levels.

A flourishing SME sector is closely associated with the growth of the country's economy and its contribution to the national GDP and employment is well-documented. SMEs in Pakistan account for 98% of all economic enterprises.<sup>10</sup> They contribute 40% to Pakistan's GDP,<sup>11</sup> a total of 25% of the country's export receipts and employing 80% of the total non-agriculture labour force.<sup>12</sup> They also contribute to 35% of manufacturing value added.<sup>13</sup> According to the 2005 enterprise survey, there are around 2.9 million SMEs; however, as per estimates, that number stands at 3.8 million as of 2013,<sup>14</sup> and is expected to be even higher in 2017.

9 (Gonzales, Hommes, & Mirmulstein, 2014)

10 (Abe, 2012)

11 (Seth, 2016)

12 (Nenova, Niang, & Ahmad, 2009)

13 (STATE BANK OF PAKISTAN, 2013)

14 (Pakistan Microfinance Review 2012, 2013)

Definition standardization will allow the financial inclusion of a larger number of firms that are currently unable to avail credit either from microfinance institutions or from commercial banks. This will help achieve the objectives of State Bank's National Financial Inclusion Strategy (NFIS). Better financial inclusion will allow for higher survival rates of these enterprises. Apart from economic benefits, this will pave the way for improved access to food, low-cost housing, low cost education, low cost healthcare and (renewable) energy.

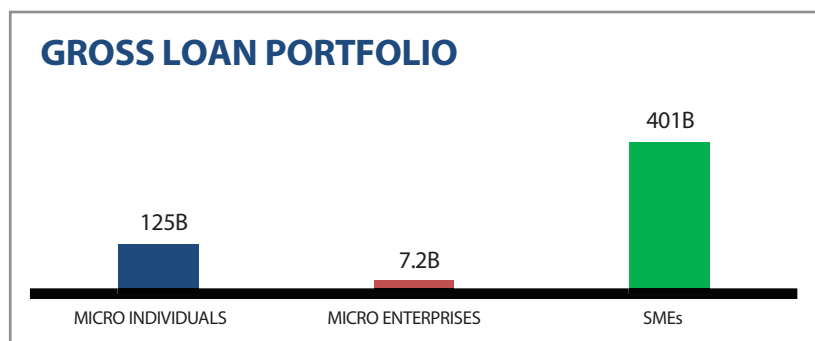
Given their economic and social importance, understanding the market segmentation of these SMEs in terms of their sectors, size and structure is necessary for developing and refining policy to support them.

## Part 2: Financing Gap and Need for Greater Segmentation

### Financing Gap

The current definitions of MSMEs leave a large proportion of enterprises unaccounted for. While large and medium sized firms have greater access to finance, it is the 'small' firms segment where access to finance is a problem. These small firms raise their own financing and 90% of this segment is underserved.<sup>15</sup> The total Gross Loan Portfolio (GLP) of SMEs stood at Rs. 401 billion as of 31 December 2016, with loans given out to a little more than 177,000 SMEs. For the microenterprises, the GLP stood at PKR 7.2 billion given to around 32,000 microenterprises. For comparison, the GLP to micro individuals was Rs. 132 billion to around 4.9 million individuals.

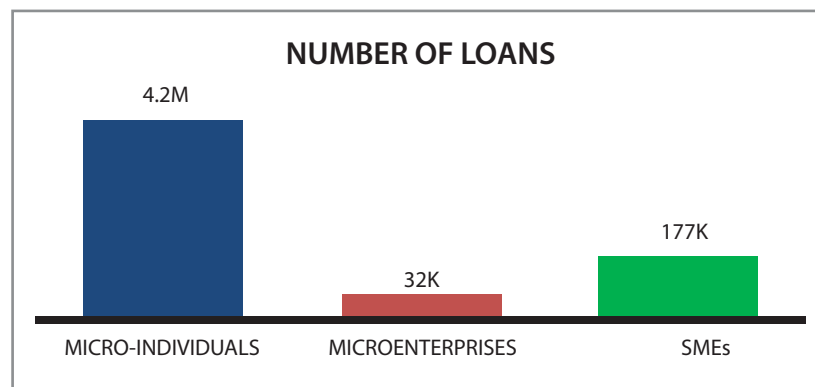
Figure 2: Gross Loan Portfolio of Microfinance & SMEs



Source: (Infrastructure Housing & SME Finance Department, 2016), (Pakistan Microfinance Network, 2017)

The corresponding number of loans are shown in Figure 3 while the corresponding average loan sizes are given below.

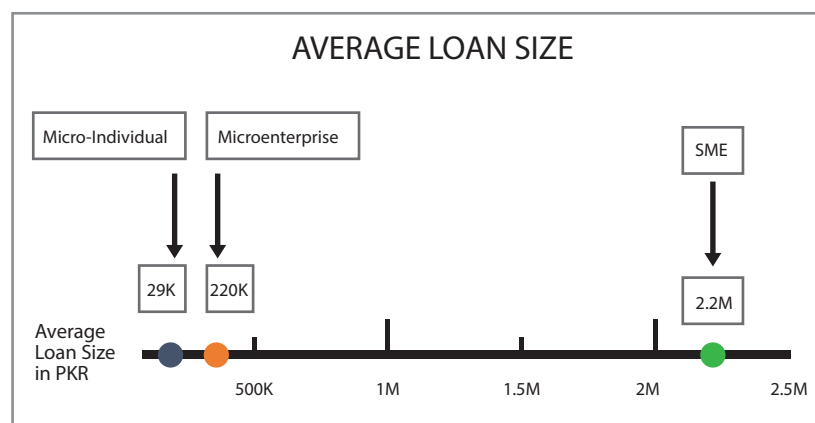
**Figure 3: Number of Loans by Category for Microfinance and SMEs**



Source: (Infrastructure Housing & SME Finance Department, 2016); (Pakistan Microfinance Network, 2017)

The corresponding average loan size is given below:

**Figure 4: Average Loan Size by Category for Microfinance and SMEs**



Source: (Infrastructure Housing & SME Finance Department, 2016); (Pakistan Microfinance Network, 2017)

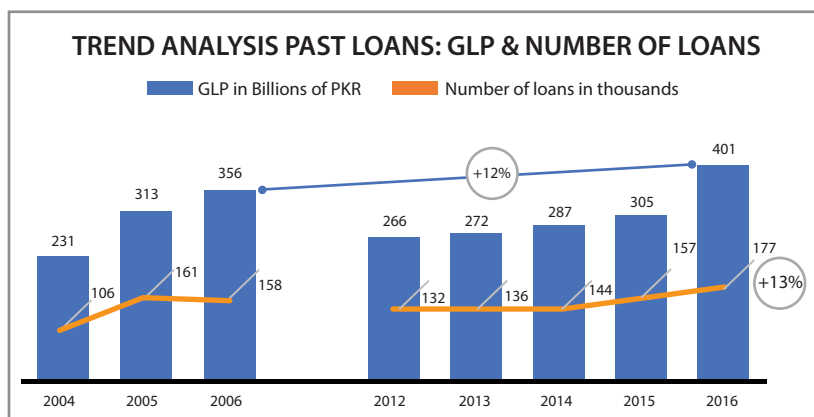
If the average loan sizes are considered, then we see from the figure above that there is a huge gap between average loan sizes when considering the Microenterprises and the SMEs. While commercial banks are often reluctant to give out small loans, and there are limitations for microfinance institutions to provide higher loans, there is a segment of enterprises which is being underserved. This segment is the segment between Microenterprises and the small segment as defined currently by the SBP.

While the average loan size only indicates the average loans given to the Small and Medium segment combined, most of the loans are being given to the 'Medium' segment while the 'Small' segment is being underserved. Due to unavailability of disaggregated data for the segment, number of loans over the past few years are analysed. In

Figure 5 below, the trend for the number of loans and the Gross Loan Portfolio (GLP) is analysed and compared for the periods 2004-2006 and from 2012 to 2016. It can be seen that there is only an increase of 12% in the gross loan portfolio in the past the years, while the number of loans given out have also increased by almost the same amount, i.e. 13%. Considering that there are 2.9 million enterprises in Pakistan as per the 2005 Economic Census (although that number is believed to be much higher now), it represents less than 6% of total loans given out to the total enterprises in Pakistan.

SME lending is increasing at a very slow rate, and we assume that this lending is going to the Medium Enterprises, and not Small. Therefore, we need to disaggregate this segment and propose new continuum where Small and Medium are separate.

**Figure 5: Trend Analysis of Past Loans for SMEs & Gross Loan Portfolio**



Source: (Infrastructure Housing & SME Finance Department, 2016)

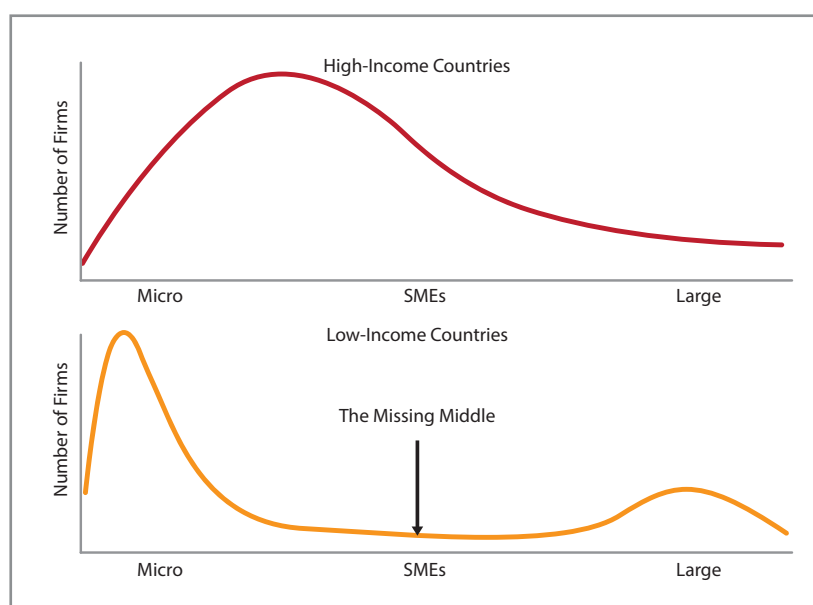
## Need for greater segmentation

While the State Bank revised prudential regulations in 2012 to cater to the financing needs of the firms at the lowest rung of the 'small' segment, there still exist a sizeable proportion of firms whose needs are not being meet either by microfinance institutions or commercial banks; these are often referred to as the missing middle .

Figure 6 on the next page further demonstrates this missing middle. In high-income countries, SMEs (5-250 employees) account for 95% of the enterprises.<sup>16</sup> However in middle and low-income countries, majority of the enterprises fall under the small segment (segment including micro- and small and all enterprises in between) which constitute around the 90% of the enterprises. This is because the 'small' firms tend to not survive due to the lack of financing available to them.

<sup>16</sup> (Advance Global Capital, 2015)

**Figure 6: Firms size distribution middle in high-income and low-income countries**



Source: (Pierre, 2013)

In Pakistan, SME lending constitutes 16% of total loans and 4% enter-prises while only 3.6% utilize these loans for investments.<sup>17</sup> Well-served SMEs are estimated at 11% of the total SME segment while 22% are underserved and 67% unserved.<sup>18</sup> Enterprise financing demand gap of PKR 277 billion is estimated in Pakistan while total SME lending stood at PKR 400 billion as of 2009.<sup>19</sup> The need to address and the 'missing middle phenomenon' requires a more in-depth review these financing concerns owing to the distribution of firms in Pakistan of SME segmentation.

## The Case for including 'Very Small Enterprises'

In 2015, the State Bank of Pakistan revealed the National Financial Inclusion Strategy (NFIS), citing a downward trend in private sector lending in real terms over the previous 5 years and that lending was disproportionately favorable towards larger enterprises.<sup>20</sup> Having greater segmentation and including an additional segment for "Very Small Enterprises" can go a long way in addressing this concern.

<sup>17</sup> (Nenova, Niang, & Ahmad, 2009)

<sup>18</sup> (Makhlouf, 2017)

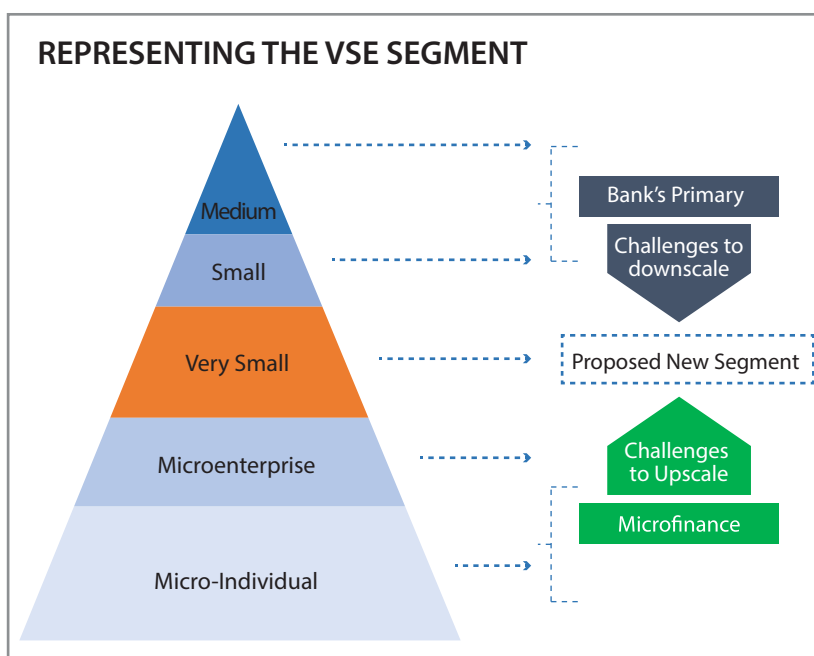
<sup>19</sup> (Nenova, Niang, & Ahmad, 2009)

<sup>20</sup> (Shankar, 2016)



Very Small Enterprise (VSE) is a segment which is typically defined as a segment between micro and small enterprises. IFC describes VSE as "... a segment that overlaps with the upper micro- and lower small enterprise segments". The actual definition of the VSE loan is given as "...a loan that has an average loan balance from 25-250 percent of GNI per capita". These loans can typically range from USD 5,000 to USD 50,000.<sup>21</sup> Looking at the typical characteristics of the VSEs, they typically have between 2 and 10 employees, are family owned and the initial capital investment is the owner's own. Often, these VSEs have fixed assets, and maintain simple financial records where records are separate for household and businesses.

**Figure 7: Illustration of Very Small Enterprise Segment**



Source: (IFC, 2015)

IFC estimates that VSEs represent 54–68 percent of formal SMEs globally.<sup>22</sup> In Pakistan, with 67% of SME segment unserved and 22% underserved, this segment will cater to those enterprises that are considered too big to avail microfinance and too risky or small for commercial finance. The defining of the VSE segment will also ensure differentiation of VSEs from the Bottom of the Pyramid enterprises and the small enterprises for targeted policy intervention.

<sup>21</sup> (IFC, 2015)

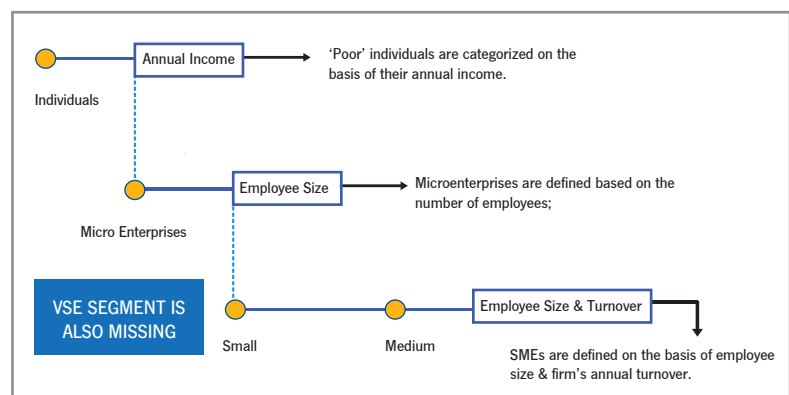
<sup>22</sup> This estimate is based on the definition of VSEs based on employee size only, i.e. between 5 and 9 employees

## Part 3: Definition Continuum - Moving from SMEs to MVSSEs (Micro, Very Small and Small Enterprises)

### Current Enterprise Definition Continuum - MSMEs and the continuum gap

Presently, with the various parameters and thresholds, there is a disconnect between the definitions of loans for individuals, micro-enterprises and the SME segment. 'Poor' individuals are categorized on the basis of their annual income, microenterprises are defined based on the number of employees whereas SMEs are defined on the basis of employee size and the firm's annual turnover. With varying parameters for each category, it is not possible to put all firm sizes on the same continuum, as demonstrated in the figure below:

**Figure 8: Current Definition Continuum Based on SBP Definitions**

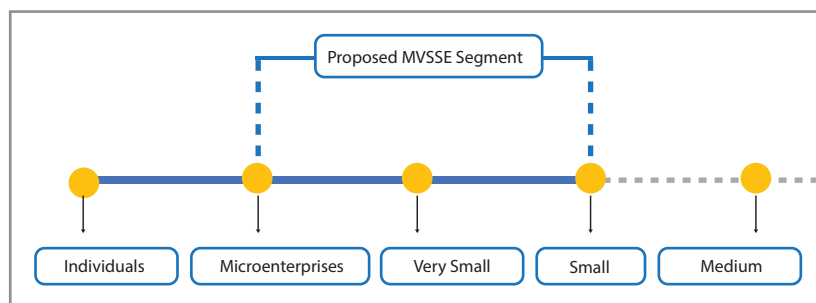


Source: Author's own contribution

### Proposed Enterprise Definition Continuum - Micro, Very Small & Small Enterprises (MVSSE)

As shown above, the use of different parameters for each category of firm size creates a disconnect. There is a need to use the same parameter, be it employee size, turnover, or both for all categories of firms to remove this disconnect. We propose that there be harmonization of definitions not only among institutions but also among the different enterprise segments. The new continuum will define all enterprises using the same parameters. Given the distribution of firms in Pakistan, we propose moving from the SME segment to the MVSSE (Micro, Very Small & Small Enterprises). This will address the need for greater segmentation and the need for targeted policy intervention to the largely underserved enterprise segment in Pakistan. Since the characteristics of individuals and enterprises are fundamentally different, we propose that the defining parameters for individuals and enterprises remains.

**Figure 9: Proposed Definition Continuum with MVSSE Segment**



Source: Author's own contribution

## Part 4:

### Definition Harmonization Evaluating Definition Parameters

As we saw above, there are different defining parameters used for different enterprise segments and by different institutions. These parameters can range from industry of operation, number of employees, annual turnover and total assets and include others, depending on the institution defining the enterprise segment. However, to have all enterprises on the same definition continuum, there needs to be harmonization in definitions among institutions and the different enterprise segments. We propose using a standard defining parameter for all enterprise segments and institutions to be on a single definition continuum. Below we will critically evaluate each defining parameter that may be used as a single measure.

### Employees Only

Total assets as a measure to categorize an enterprise leads to a lot of challenges in measurement and valuation. Enterprises often undervalue their assets for tax purposes and this measure also does not consider the efficiency of the assets. The increase in use of assets leads to greater depreciation in value of the asset, which also gives a wrong notion of linking value of assets to economic growth. MSMEs are often run by a sole proprietor and run as family businesses. They are also not able to differentiate between the private and business use of the assets, compounding the 'measurement of assets' problem. While the IFC uses this as a parameter in defining MSMEs, this measure as a standalone would be less viable in Pakistan.

23 (Gibson & Vaart, 2008)

24 (Bloem, 2012)

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## Employees and Turnover

Employees and Turnover are currently both used in Pakistan as defining parameters for SMEs. Using both the number of employees and annual turnover creates categorization problems for firms that, given the nature of their work, may have different labor requirements to get the same turnover. Although the current regulations by the SBP recognize this to some extent and provide a different threshold for enterprises operating in the Manufacturing and Trade sub-sectors, variations can exist among other industry sub-sectors and even within the same industry. Different technological requirements and production techniques would also pose a problem with defining the firm within its respective category.

Another challenge with using both these parameters is that a firm that meets threshold for one parameter and not the other would automatically get categorized in a different category. For example, a firm with 49 employees with revenue of Rs. 100 million is characterized as small. However, if another firm had 51 employees, the same firm would be categorized as a medium enterprise.<sup>26</sup> Hence, business sizes can vary depending on the industry of operation and even within industries.<sup>27</sup> Furthermore, enterprises may also under-report their annual turnover for financial reporting. The advantage of having this measure would be that as it is currently in use as a measure, it would be easier to implement this for the 'microenterprise' segment and the 'very small' segment.

## Turnover only

Turnover is 'perhaps our best bet for accurately measuring an SME'.<sup>28</sup> This criterion may also indicate which organizations are likely to grow. Intuitively, reference to size of businesses is made in terms of turnover,

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25 (Dr.P.M.Mathew, 2014)

26 According to the State Bank of Pakistan definitions

27 (Berisha & Pula, 2015)

28 (Bloem, 2012)

rather than assets or employees. While differences are likely to exist between enterprises that operate in different sub-sectors in terms of sophistication of work with identical turnover, however, it is likely that the two companies will share same organizational attributes.<sup>29</sup> It is also beneficial to use turnover for measuring a firm size because it can easily be converted to a dollar value and make comparisons easy and the turnover information is also more readily available.<sup>30</sup> It should be noted, however, that using this measure also has challenges because of inconsistencies in financial reporting and there are arguments that cash flow is a better indicator of the health of an enterprise.<sup>31</sup>

## Alternative Definition

While there are arguments about the indicators used to define SMEs, there have been attempts to propose different and varying definitions. The first step in formulating a definition should be the purpose for which the segment needs to be defined. The broader objective and the more specific objectives will form the guiding principles for definition.

Tom Gibson and H. J. van der Vaart proposed that MSMEs be defined as having an annual turnover 'between 10 and 1000 times the mean per capita gross national income, at purchasing power parity, of the country in which it operates.'<sup>32</sup> This definition has its merits as turnover may be a good criterion to measure contribution of MSMEs to the GDP; however, it is argued that data on annual turnover may be difficult to obtain compounded by phenomenon of a large number of informal MSMEs in the economy.<sup>33</sup>

Turnover alone cannot be a standalone measure of a firm size; it is important to define the turnover relative to its size within its environment. For example, an e-commerce company in Pakistan with annual turnover of USD 1 million will be a much larger company than an e-commerce start-up in the Silicon Valley in USA. The same difference may also be applied to different sub-sectors within the economy to which the same formula may be extended.

## Application of the formula in Pakistan

When the formula is applied on the per capita GNI at PPP in 2007, the annual turnover is Rs. 251 million, which is roughly the same turnover as used in the SME policy 2007. If the same formula is applied for 2014, the formula gives a turnover of Rs. 509 million, hence the formula would imply that the annual turnover threshold for SMEs need to be

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29 (Berisha & Pula, 2015)

30 (Gibson & Vaart, 2008)

31 (Berisha & Pula, 2015)

32 (Gibson & Vaart, 2008)

33 (Dr.P.M.Mathew, 2014)

raised to Rs. 509 million.<sup>34</sup> *(further research is required to provide detailed segment-wise limits based on the formula)*

## Our proposed formula to include industry sub-segments

Within the context of Pakistan, first there needs to be segmentation of the MVSSE industries, and based on the sub-sector of the economy, the same formula may be applied for more precise policy intervention within sub-sectors. The proposed new MSMEs should be defined as having annual turnover of between 10 and 1000 times the mean per capita gross national income, at purchasing power parity, of the industry sub-sector in which it operates. However, we propose this be done at a later stage, once the framework is in place.

## Proposed new definitions

The proposed formula provides an overall definition of the MSME segment. To define thresholds by the same formula requires data on GNI contribution classified by industry sub-sector and size of firm. Due to limited data availability, we have come up with proposed new limits that may serve as guidelines for policymakers to agree on a definition.

Based on the current SBP definition, we use firms' revenue turnover as a starting point for 'small' enterprises and work backwards to devise different thresholds.

## Assumptions

Before proposing new definitions in Pakistan, some assumptions need to be clarified:

- Arbitrary values of the multiples have been assumed. These are subject to change as per discussions between State Bank of Pakistan and other stakeholders.
- The credit limits are fixed at 40% of revenue in case of enterprises and individual's income. This standard is applied across all categories; this is also subject to change after discussions.
- Multiples have been derived working backwards from the current SBP loan limits for Small enterprises, micro enterprises and micro individual loans. Multiples and limits for 'Very Small' segment are based on arbitrary difference between Micro and Small.
- This paper only suggests a framework within which to work. Final values and multiples and limits would be subject to change based on inputs from the stakeholder and SBP

## Proposed Threshold for MVSSE segment

Based on the revenue as a proxy measure for firm size, the proposed new revenue limits (as multiples) are given below. These multiples provide a mechanism through which limits may be set and reviewed in the future. By proposing definitions as a function of GNI at PPP, it makes the threshold more dynamic. Since the definitions are linked to a key economic indicator, it will ensure that the limits are updated periodically, making the comparison over time and across different countries more convenient.

**Table 8: Proposed New Threshold as Function of GNI-PC/PPP**

PROPOSED NEW THRESHOLD AS FUNCTION OF GNI-PC/PPP				
	INDIVIDUAL	MICRO	VERY SMALL	SMALL
LOWER REVENUE LIMIT (as multiples of GNI-PC/PPP)	0.4* GNI-PC/ PPP	0.75* GNI-PC/ PPP	2.5* GNI-PC/ PPP	50* GNI-PC/ PPP
UPPER REVENUE LIMIT (as multiples of GNI-PC/PPP)	0.75* GNI-PC/ PPP	2.5* GNI-PC/ PPP	50* GNI-PC/ PPP	125* GNI-PC/ PPP

Applying these new limits for determining new thresholds gives us:

**Table 9: Proposed New Threshold Definitions by Turnover**

PROPOSED NEW DEFINITIONS BY TURNOVER				
	INDIVIDUAL	MICRO	VERY SMALL	SMALL
LOWER REVENUE LIMIT	203,600	381,750	1,272,500	25,000,000
UPPER REVENUE LIMIT	381,750	1,272,500	25,000,000	63,625,000

Rounding off these limits gives us the following:

**Table 10: Comparison to the Current Definitions Factoring Only Revenue**

COMPARISON TO THE CURRENT DEFINITION FACTORING ONLY REVENUE								
	INDIVIDUAL		MICRO		VERY SMALL		SMALL	
	FORMULA	SBP	FORMULA	SBP	FORMULA	SBP	FORMULA	SBP
LOWER REVENUE LIMIT	-	-	380,000	-	1,300,000	Not Defined	25,000,000	-
UPPER REVENUE LIMIT	380,000	500,000	1,300,000	< 10 Employees	25,000,000	Not Defined	64,000,000	150,000,000

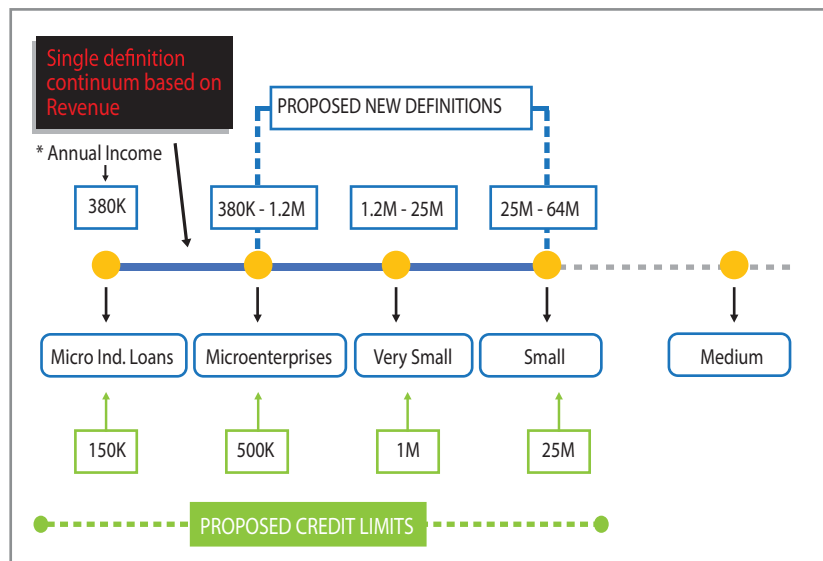
Assuming that the credits limits for each category are based on 40% of their revenue/income, we get the following upper and lower credit limits:

**Table 11: Proposed new credit limits for each category**

PROPOSED NEW CREDIT LIMITS				
	INDIVIDUAL	MICRO	VERY SMALL	SMALL
LOWER CREDIT LIMIT	-	150,000	500,000	10,000,000
UPPER CREDITLIMIT	150,000	500,000	10,000,000	25,000,000
SBP UPPER LIMITS	150,000	500,000	Not defined	25,000,000

Source: Author's own contribution

**Figure 10: Proposed new definition continuum** (all numbers in PKR)



Source: Author's own contribution

## Discussion: Defining parameters and credit limit

Applying the formula and a uniform threshold of 40% across individual, micro, very small and small enterprises gives us a new continuum as shown in the figure above. The credit limit for 'very small' enterprises is a new segment, and it is thus useful to have a mechanism through which a lending limit can be allocated. For all the other segments, the limits are currently the same as defined by the SBP. However, these limits have been derived through a framework/mechanism and will provide a formal mechanism through which periodic reviews may take place. this is a process which would require input from industry and regulatory experts and a starting point to finalize a mechanism for determining defining the segment and the credit limits.



## Rationale for definition harmonization and policy implications

With the formulation of the National Financial Inclusion Strategy, it is important to recognize the financing gaps faced by these missing middle firms. Tackling their financial exclusion can have effects on the economy at a broader level since micro and small firms play a critical role in the economy of Pakistan. Understanding the market segmentation of these micro and SMEs in terms of their sectors, size and structure is important for developing and refining policy to support them. With supportive policies and sufficient financing in place, they can play a key role in promoting innovation, economic growth, poverty alleviation, social inclusion, promotion of exports.<sup>35</sup>

Despite significance of the SME segment to the national economy, only 16% of total lending is channelled to SMEs and they account for only 4% of total customers in the country.<sup>36</sup> Large and medium sized firms have greater access to finance howbeit the 'small' firms segment is the one where access to finance is a problem. There still consist a sizeable proportion of firms whose needs are not being meet either by microfinance institutions of commercial banks. At the same time, the micro individual and the micro enterprise loans are determined using different thresholds than that of the SME sector. Redefining the definition continuum and having greater segmentation will allow for more focused approach and a holistic view of access to finance across different segments.

SMEs in Pakistan account for 98% of all economic enterprises.<sup>37</sup> They contribute 40% to Pakistan's GDP,<sup>38</sup> a total of 25% of the country's export receipts and employing 80% of the total non-agriculture labour force.<sup>39</sup> They also contribute to 35 percent of manufacturing value added. According to the 2005 enterprise survey, there are around 2.9 million SMEs; however, as per estimates, that number stands at 3.8 million as of 2013,<sup>41</sup> and are expected to be even higher in 2017.

A flourishing SME sector is closely associated with the growth of the country's economy and its contribution to the national GDP and employment is well-documented. SMEs are a very heterogenous category with enterprises operating in various sectors within the economy comprising of both formal and informal sector, varying methods of operation and differing maturity levels.<sup>42</sup> Understanding the market segmentation of these SMEs in terms of their sectors, size and structure is important for developing and refining policy to support them.

35 (Abe, 2012)

36 (Nenova, Niang, & Ahmad, 2009)

37 (Abe, 2012)

38 (Seth, 2016)

39 (Nenova, Niang, & Ahmad, 2009)

40 (STATE BANK OF PAKISTAN, 2013)

41 (Pakistan Microfinance Review 2012, 2013)

42 (Blackburn, June 2012)

## Part 5: Conclusion

Major global institutions around the world define MSMEs with different set of parameters and thresholds. The problem is compounded by the fact that along with these global institutions, the local governments and institutions have their own definitions of MSMEs. These definitions are seen to be adapted from other countries, often with different business environment and macroeconomic conditions. Looking at the SME demographic landscape in Pakistan, more than 97% of the enterprises are MSMEs and multiple definitions are used. The size distribution of enterprises demands that a more granular approach towards segmentation be taken and the definitions of enterprise be updated keeping in view the local macroeconomic conditions and economy.

There is a need to address the disconnect that exists between micro-enterprises and SMEs. This should be done by moving from a separate segmentation of micro and SMEs to 'Micro, Very Small and Small' firms (MVSSs). The introduction of a 'very small' segment would help to account for the firms that can neither be categorised as micro or small given their turnovers. Formally recognising this segment will help close the financing gap that exists between microenterprises and small firms. This, in turn, would help tackle the problem of a 'missing middle' in Pakistan.

Furthermore, the current definitions rely heavily on number of employees and annual turnover to determine the size of the enterprise. While turnover may be a suitable parameter to gauge the size of an enterprise, the labour determinant may be misleading as it does not take into account labour efficiency and the capital-labour ratio with which different enterprises operate within different industry sub-segments. A proposed alternate definition for SMEs is to define them in relative terms based on their annual turnover and their relative contribution towards the per capital Gross National Income at purchasing power parity within the industry sub-segment in which it operates in. It must be taken into account that the multiples used in the alternative formula presented above, and the limits derived using these multiples, both for the revenue and loan size, are arbitrary figures. However, they provide a strong basis for developing a framework on which further policy can be defined for each firm segment, from micro, very small and small firms. It is imperative to have a mech-

anism in place and to set out objectives in order to provide a formal framework for defining the MVSSE industry and to move away from the SME segment.

The primary reason for having detailed definitions is to have targeted policy intervention. Whatever defining parameters that are used, overall, there needs to be harmonization of definitions with generally acceptable methodology backed by objective rationale and parameters and a permanent review mechanism to review and evaluate these definitions.

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Authored by: Jaffar Jassim & Maham Khawar

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Islamabad, Pakistan

Tel: +92 51 229 2231, +92 51 226 6215-17, Fax: +92 51 226 6218, Email: [info@pmn.org.pk](mailto:info@pmn.org.pk)  
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