



# COERCIVE STATE AND THE FLEDGLING ENTERPRISES IN SHARAQPUR BAZAAR

A SURVEY OF FORMAL AND INFORMAL ECONOMY

Asad Ullah

*In Collaboration with*

Friedrich Naumann  
STIFTUNG **FÜR DIE FREIHEIT**

# **State Coercion and the Fledgling Enterprises in Sharaqpur Bazaar:**

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A Survey of Formal and Informal Economy

Asad Ullah

PRIME is an economic policy think tank working for an open, free and prosperous Pakistan by creating and expanding a constituency for protective function of the state and freedom of the market.

This study titled "State Coercion and the Fledgling Enterprises in Sharaqpur Bazaar: A Survey of Formal and Informal Economy", by Asad Ullah, is based on a survey of 100 small scale enterprises based in Sharaqpur, a small town near Lahore. The study aims at understanding the dynamics of small scale entrepreneurs as they interact with with the government on their path of survival and growth. The study provides an inventory of workable recommendations requiring changes in the laws, regulations, and attitude that these industrious entrepreneurs face on daily basis.

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## Preface

It's a wonder in itself that in modern age—when states purchase the latest information systems available, and hire the shrewdest statisticians out of the college to keep an eye on every single paisa transferring from one hand to another—how informal businesses manage to remain invisible before the state's eye, keep working and growing? States continuously devise different regulations, and send their officials to control the phenomenon of informal economy. But like the many heads of hydra, the more the cut, the more heads emerge. The phenomenon needs to be studied.

The Peruvian economist Hernando De Soto studied this phenomenon and found that problem was not with the informal economy, the problem was with the state. The presence of very complex regulations, purposeless official procedures and corrupt officialdom not only pushed the informal entrepreneurs into informality but it closed the doors of lawful possession of property for them. De Soto, who took more pride in calling himself an activist instead of an economist, also conducted an experiment. When the regulations were softened, the procedures were simplified and property rights were easily available, most of the informal businesses got them formalized.

We see a perfect ground to recreate a similar experiment in Pakistan. The time has come that one considers the real reason why the informal economy is not coming inside the tax net. Instead of labelling industrious people as *taxchor*, and their ethically earned money as *kaladhan*, and their bread and butter the black economy—because these people tried to make maximum out of what they had, and tried to save them from harassment of the officialdom by remaining invisible—the state needs to take a sympathetic view of the matter, bring its own house in order and let these entrepreneurs come into the formal economy.

By simplifying regulations, decreasing corruption, debottlenecking procedures, lowering tax rates and making it easier for them to own their business premises, a lot more businesses can be brought into the formal sector, than coercion, penalties, punitive taxes, heavy fines and demolition of buildings with earthmoving machinery can collectively bring because no amount of coercion can outsmart the acumen and ambition of an entrepreneur.

Author

## 1. Informal Economy: A Desk Review

A number of stake holders define informal economy as a part of the economy, which is neither taxed, nor monitored by the state, nor included in any of the Gross National Product (GNP) of any country.<sup>1</sup>

According to legalist school, championed by Hernando De Soto, Informal businesses are small businesses those chose to remain informal to avoid the cost, the time it takes to get registration, and the effort it requires to get registered.<sup>2</sup> De Soto also coined the word “Extra-legal” to describe informal entrepreneur and economy instead of the derogatory word “illegal” which was previously used for the same concept.

De Soto’s coined word “Extra-legal” is getting popularity in Pakistan. In a conference, organized by Centre for International Private Enterprise (CIPE) and Karachi Chamber of Commerce and Industry (KCCI), it was agreed that “informal sector” was not synonymous with “black economy” as the later implied illicit and criminal activities. Similarly, it was agreed upon that word “extra-legal” should be preferred over the word “illegal”, while explaining the informal economy. In the same conference it was observed that by lowering the barriers of entry and by facilitating the entry of informal businesses into the formal ones, a lot of new opportunities can be created.<sup>3</sup>

It may also be noted that informal economy was not limited to the unregistered firms only. Bad corporate practices like

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<sup>1</sup> Kaushik, P.D. “Formal & Informal Entrepreneurship,” Liberty Institute, Delhi, 2013, p.4

<sup>2</sup> Ibid. p.3

<sup>3</sup> “How to formalize the Informal Sector?” Dawn. Karachi, 19<sup>th</sup> December, 2011, [URL accessed on 12<sup>th</sup> June, 2014: <http://www.dawn.com/news/681607/how-to-formalise-informal-sector>]

hoarding, speculation, tax evasion, and financial trickeries in registered firms also increased the size of undocumented economy.<sup>4</sup>

P.D. Kaushik did his study on formal and informal businesses in Delhi with a legalist view and a number of his findings seemed applicable to other cities of the subcontinent, when we reviewed it. He held that “Archaic Colonial Laws” pushed extra-legal businesses towards vulnerability of extortions.<sup>5</sup> We believe, though postcolonial developments in law making were based on the same British Indian set of laws in Pakistan and India. However, owing to the different set of circumstances which succeeded in both of the countries the legal developments evolved in different directions. Where India faced a prolonged license raj which pushed the small businessman to the wall, Pakistan experienced alternate stints of martial laws and civilian elected governments and a certain unexpectedness which kept the businessmen in limbo and for decades, Indian political leadership had an acclivity towards Soviet Union, an icon of socialism whereas Pakistani statesmen inclined towards United States, an effigy of capitalism. This independent evolution of legislation and in consequence institutions makes it difficult to generalize the social and economic findings in one country to the other.

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<sup>4</sup> “Expanding the Informal Economy.” Dawn. Karachi, 13<sup>th</sup> June, 2005, [URL accessed on 28<sup>th</sup> June, 2014: <http://www.dawn.com/news/143173/expanding-the-informal-economy>]

<sup>5</sup> Kaushik, P.D. “Formal & Informal Entrepreneurship,” Liberty Institute, Delhi, 2013, p.122

## Size of Informal Economy

No one knows the exact size of informal economy in Pakistan yet there are estimates ranging from one third to one half of the total economy, depending on whom you ask. Through K&Q or Kemal and Qasim technique based on private household consumption and official Gross Domestic Product (GDP), Kemal and Qasim estimated that informal economy was equal to 91 percent of GDP in Pakistan for the year 2007-08. They also gave a conservative estimate: if the household consumption was over-reported by ten percent, the informal economy was 78 percent of the GDP during the said period.<sup>6</sup>

In another study, Kemal estimated that the relative size of underground/informal economy fluctuated as a percentage of GDP over the years. It increased in the years 1991 to 1998 and decreased between the year 1998 and 2002.<sup>7</sup> Another recent argument, championed by Ali Kemal of Pakistan Institute of Development Economics (PIDE), is that Informal sector was shrinking in its size because the electricity shortage was hitting the informal sector more severely than the formal one. However, as the writer Nasir Jamal noted, Kemal did not give a new estimate of the percentage of informal economy in relation to the formal economy.<sup>8</sup>

However, some writers have another opinion like Sakib Sherani pointed out a downward trend in successive years regarding the listing of new businesses on the stock exchange. Mr Sherani also observed that previously formal businesses opted for informality

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<sup>6</sup> Kemal, Muhammad Ali and Qasim, Ahmed Waqar, "Precise Estimates of The Informal Economy," PIDE, Islamabad, 2012 p.8.

<sup>7</sup> Kemal, Muhammad Ali. "Underground Economy and Tax Evasion in Pakistan: A Critical Evaluation," PIDE, Islamabad, 2003 p.43

<sup>8</sup> Jamal, Nasir. "Is Informal Economy Shrinking?" Dawn. Karachi, 2<sup>nd</sup> June, 2014. [URL accessed on 21<sup>st</sup> June, 2014: <http://www.dawn.com/news/1110027>].

newly. And large manufacturing units outsourced their production operations from the informal businesses.<sup>9</sup>

And related portions of formal and informal economies vary sector wise. Baloch observed that proportion of formal and informal economy varied across sector to sector. For instance, one fourth of the tobacco trade fall in the informal sector, whereas 90 percent of the milk sold in the country was in informal sector<sup>10</sup>. Similarly in 2003, 80 percent of the paint market in Karachi was being catered by informal manufacturers as formal businesses were not able to compete due to 10 percent duty imposed on their product by the government.<sup>11</sup>

### **Informal Businesses and Labour Force**

To cite Dr. Kaushik, labour is the most important input of an informal economy. However, their welfare was often neglected.<sup>12</sup> Dr. Kaushik also reasoned that Globalization due to its reliance on capital more than on labour left no choice for the labour force except for moving towards the informal sector.<sup>13</sup>

By absorbing a large portion of the labour force, informal businesses are indeed rendering a national service. According to

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<sup>9</sup> Sherani, Saqib. "The Informal Economy," Dawn. Karachi, 13<sup>th</sup> February, 2013. [URL accessed on 8<sup>th</sup> April, 2014: <http://www.dawn.com/news/787833/the-informal-economy>].

<sup>10</sup> Baloch, Farooq. "Clouded Future: Tap and tax the informal economy." Express Tribune. Karachi, 2<sup>nd</sup> June, 2014. [URL accessed on 1<sup>st</sup> July, 2014: <http://tribune.com.pk/story/716168/clouded-future-tap-and-tax-the-informal-economy/>].

<sup>11</sup> Khan, Aamir Shafaat. "Informal Paint Makers Capture 80pc Market," Dawn. Karachi, June 26<sup>th</sup>, 2003. [URL accessed on 11<sup>th</sup> August, 2014: <http://www.dawn.com/news/108223/informal-paint-makers-capture-80pc-market>].

<sup>12</sup> Kaushik, P.D. "Formal & Informal Entrepreneurship," Liberty Institute, Delhi, 2013, p. 5.

<sup>13</sup> Ibid. p. 6.

Labour Force Survey Pakistan 2012-13, informal sectors provided 73 percent of non-agricultural employment. The ratio was more in rural areas (77.4 percent) than urban (69.9 percent.) Among them, 2.5 percent were employers, while 40.5 percent were self-employed, whereas 10.2 percent were contributing family workers and the rest 46.8 percent were employees.<sup>14</sup>

Similar statistics were presented by Umme Laila (Social Activist), she thinks in Pakistan as much as 74 percent workers earned their living through informal sector and among these 65 percent were home based and 85 percent of the home based workers were women. According to Ms. Laila these workers were deprived of the access to social security.<sup>15</sup>

And according to another notable, All Pakistan Women's Association (APWA) chairperson Ruhi Sayyid, a significant portion of informal economy approximately 8.5 million workers were employed in domestic sector. Due to lack of labour laws covering these domestic workers they were exposed to a number of abuses and exploitations.<sup>16</sup>

We are not sure if mere legislations will help protect the home-based and domestic workers because historically state turning a blind eye towards implementing labour and occupational safety regulations, sometimes has resulted in unpleasant accidents of

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<sup>14</sup> Pakistan Bureau of Statistics. "Labour Force Survey 2012-13," Statistics Division, Government of Pakistan, Islamabad, November 2013, p. 27.

<sup>15</sup> Newspaper Correspondent. "Call for Protection of home based workers." Dawn. Karachi, 15<sup>th</sup> October, 2013. [URL accessed on 28<sup>th</sup> June, 2014: <http://www.dawn.com/news/1042909>].

<sup>16</sup> Naqvi, Hassan. "Informal Labour: Domestic workers to get trainings, rights, education." Express Tribune. Karachi, Feb 25, 2014. [URL accessed on 13<sup>th</sup> July, 2014: <http://tribune.com.pk/story/675719/informal-labour-domestic-workers-to-get-training-rights-education/>].

factory fires which claimed dozens of lives in Lahore and Karachi.<sup>17</sup>

### **Regulations, Corruption and Informality:**

According to Hernando De Soto, a large part of Peruvian economy was pushed into informality due to the excessive regulations, and this prevented the economic growth of the Latin American country.<sup>18</sup>

A similar trend was recorded by Dr. Kaushik in his Delhi study. He observed that due to the demand to comply with a number of regulations, extra-legal businesses found it unappealing to get formalized and even when they did want to formalize them, the official machinery resisted their transition because if these businesses got formalized, their rent seeking would have been decreased.<sup>19</sup>

Informal businesses also received a few benefits in Delhi like they used utilities at a domestic rate instead of commercial rate. Yet to avoid harassments, they had to pay bribes to the officials regularly. These bribes often outweighed the amount of savings received in this way.<sup>20</sup>

### **Property Rights**

De Soto puts special emphasis on the access to the property rights and lack thereof. In Pakistani context, citing a few empirical studies, Javed suggested that intergenerational poverty

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<sup>17</sup> Dawn, Karachi. 10<sup>th</sup> December, 2013, "Informality and the Private Sector." [URL accessed on 23<sup>rd</sup> July, 2014: <http://www.dawn.com/news/1061604>].

<sup>18</sup> Kaushik, P.D. "Formal & Informal Entrepreneurship," Liberty Institute, Delhi, 2013, p. 5.

<sup>19</sup> Kaushik, P.D. "Formal & Informal Entrepreneurship," Liberty Institute. Delhi, 2013, p. 39.

<sup>20</sup> Kaushik, P.D. "Formal & Informal Entrepreneurship," Liberty Institute. Delhi, 2013, p. 83.



had a connection with the denial of the access to agricultural and residential land and poverty prevailed more in land-less castes as than land owning castes.<sup>21</sup>

Faisal Bari noted that Pakistan was among the countries where state owned relatively large chunks of urban land as compared to some developed countries. He suggested that this land could be commercialized in an efficient manner. However, he also deplored that land titling system was not very well-organized and land related disputes made it unpalatable to sell or purchase land.<sup>22</sup>

To ensure a smooth land titling system, recently a relatively large scale project is going on in Punjab to computerize land record systems<sup>23</sup> and we expect it will make the land transfer and property rights easier and safer in the long run. But the anecdotal evidence is quite the contrary and currently parallel systems of land record are working in Punjab both manual and computerized, side by side. This parallel system makes land transfer more difficult instead of facilitating it.

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<sup>21</sup> Javed, Umair, "Attention deficit." Dawn. Karachi, 26<sup>th</sup> May 2014. [URL accessed on 19<sup>th</sup> July, 2014: <http://www.dawn.com/news/1108531>].

<sup>22</sup> Bari, Faisal. "The Housing Sector." Dawn. Karachi, 5<sup>th</sup> July, 2014. [URL accessed on 24<sup>th</sup> July, 2014: <http://www.dawn.com/news/732014/the-housing-sector>].

<sup>23</sup> APP: "Patwari Culture: Computerization of Land Records in 114 Tehsils," Express Tribune. Karachi, 1<sup>st</sup> June, 2014. [URL accessed on 17<sup>th</sup> June, 2014: <http://tribune.com.pk/story/715967/patwari-culture-computerisation-of-land-record-in-114-tehsils/>].

## Attempts to bring Informal Businesses to the Mainstream in Pakistan, and why they need to be brought into the Mainstream?

Referring to a contemporary study by Federal Bureau of Revenue (FBR), Dawn stated that no successive government took any concrete steps to curb the issue of increasing informal economy. Save for a short term initiative to formalize the informal sector during Shaukat Aziz working as finance minister in 2000-2001. However, this program was called off due to the resistance offered by informal businessmen. <sup>24</sup>

State is constantly using indirect taxes like withholding tax as a punitive measure to make it unbearable for the businesses to remain informal. But over the years this cure has itself become the disease. Former Governor of the State Bank, Dr. Ishrat Hussain, mentioned in his column that reliance on indirect taxes is so high in Pakistan that only less than 1.1 percent of GDP was being collected as “actual direct income tax.”<sup>25</sup>

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<sup>24</sup> Dawn: Karachi, 1<sup>st</sup> October, 2012, “Growing Informal Economy.” [URL accessed on 28<sup>th</sup> July, 2014: <http://www.dawn.com/news/753254/growing-informal-economy>].

<sup>25</sup> Hussain, Ishrat. “Stubborn Taxation Regime,” Dawn. Karachi, 11<sup>th</sup> March, 2014. [URL accessed on 19<sup>th</sup> June, 2014: <http://www.dawn.com/news/1092349>].

**For the State:**

Other than lost tax revenue the relative growth in informal sector posed a challenge before the policymakers. Due to lack of complete information, the monetary and fiscal policies became less reliable and were difficult to be formed correctly.<sup>26</sup>

**For the Businesses:**

Kaushik held that though extralegal businesses survived without any assistance from the government. However, their property rights were not secure and they were unable to deploy formal instruments like institutional financing, equity trading, monetizing the virtual property etc. because these kinds of facilities can only be enjoyed with the help of a legal status of the business. And in the absence of such kind of amenities, extralegal businesses had to work really hard to prosper.<sup>27</sup>

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<sup>26</sup> Dawn. Karachi, 7<sup>th</sup> September, 2009, "Informal Economy and its impact."  
[URL accessed on 12<sup>th</sup> July, 2014:  
<http://www.dawn.com/news/489278/informal-economy-and-its-impact>].

<sup>27</sup> Kaushik, P.D. "Formal & Informal Entrepreneurship," Liberty Institute. Delhi, 2013, p. 122.

## 2. Methodology

### Study Design

This is a survey based study and focuses on small formal and informal businesses in relation to the problems and facilitations received from the government, the financial institutions, the contract enforcement agents and how these businesses run their operations or business processes.

### Data Sources:

#### Primary Data:

Primary data was collected from 100 businesses situated in Sharaqpur (a small town in Northern Punjab near Lahore) through structured survey and focus group discussions. These businesses are mostly small scale enterprises dealing in trading, agriculture produce, tools and equipment, repair services etc.

#### Secondary Data:

Secondary data was collected from books, published studies, newspapers, and Pakistan Bureau of Statistics.

#### Instrument:

Two versions of the questionnaire were developed, the original in English and its Urdu translation. Most of the respondents opted for the Urdu version. Open and close ended questions were asked in the questionnaire. A few respondents filled their questionnaires on their own while most preferred getting their responses noted by the researcher or his assistant in a structured interview type fashion. Many of the respondents shared their experiences to the degree that was not asked in the questionnaire we designed.

## Survey

The initial plan was to conduct a survey from a random sample of respondents. But this approach did not work as respondents exhibited a stern lack of trust due to their perceived fear from government officials. Therefore, to approach the respondents we took referrals from different people like office bearers of local trade associations and businessmen of good repute. However, special care was taken to make it a representative sample instead of a sample tilting towards any single set of respondents

## Focus Group Discussions:

To validate the results of survey, two focus groups discussions were arranged among the selected group of businessmen in Sharaqpur. Most of the responses were in agreement to the survey results. They also provided additional information which was helpful in comprehensive analysis of the survey results.

## Limitations:

The primary data was only collected from the formal and informal businesses. Authorities, Bankers, or Tax-men were not contacted, so the study may not reflect their version of truth or justifications.

Sample selection biases may occur while generalizing this study to very big cities where situations and challenges faced by a small entrepreneur may not be the same as for the study population.

### 3. Site Selection: Sharaqpur

Town of Sharaqpur is located at longitude  $74^{\circ}6'0''E$ , and latitude  $31^{\circ}27'48''N$ , 32 kilometres away from the city of Lahore. It is a small town and economic opportunities consist of trade, services and agriculture. Administratively, Sharaqpur is a Tehsil of District Sheikhupura in Punjab Province. It consists of one urban and seven rural union councils a total of 127 villages. Most of these villages depend on the educational institutions, banks and marketplace in Sharaqpur for their educational, financial and day to day needs. The study site is the marketplace in the urban union council, the union council number 45.

According to an estimate current population of Sharaqpur is 40,000 and there are around 1,500 businesses working in the town most of them in services and trade sector. For years inflow and outflow of migratory population has maintained a balance. Its population grew only three folds during the censuses of 1951 and 1998, during the same period populations of large cities such as Karachi and Gujranwala grew nine times. The local migration from nearby villages to Sharaqpur also contributed to the population growth.

Though Sharaqpur is a small town but it shows some salient features of urbanization like clusters of related businesses, educational institutions, parks, government offices, market places, banks, gated communities, suburbs with villas of affluent people along with slums with make-shift cottages for the down trodden. Downtown is an old walled city called *Androon-e Sharaqpur*. But in the absence of any conservation effort, years of monsoon rains and commercialization of circular road have washed away the traces of the city wall—commercialization more often than monsoon. *Androon-e Sharaqpur* is the heart of town's business and hosts the key business street called *Main*

*Bazar*. The hustle and bustle of customers on a week day competes with any busy commercial street of major cities. All the transactions are done in cash. And small instances of occasional cash snatching and shop robbery do not bother the traders too much and are part of the business as usual. Most of these traders are informal businessmen and are earning a living without any government help or financing from the banking sector. Since *Androon-e Sharqpur* is a motor-less county, many businesses which deal in bulky items have shifted their businesses on the outer, bigger, and wider streets.

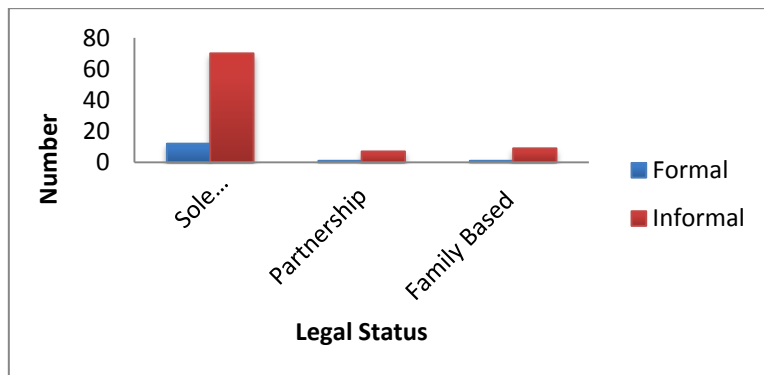
Financial market is rather mature for a small town. Five commercial banks, one agricultural bank, one Islamic bank and an office of National Savings provide their services. Major microcredit organizations and a number of branchless banking outlets are also functional. But common shopkeepers are not one of the basic beneficiaries of this financial infrastructure. Sharaqpur is not an industrial town but a four lane dual carriage way connects it to nearby industrial towns Mandi Faizabad and Lahore and a two lane single carriage way, with Sheikhupura. Businesses in Sharaqpur have limited access to formal capital and anecdotal evidence suggests that savings by local population may be directed to extend credit to the industrial entrepreneurs in the nearby industrial areas. Microfinance firms are doing a good job but the low volumes of the individual loans issued by a microcredit organization is usually too small to produce any significant growth in a small business.

## Survey Results

### 4. Business Profile

This section throws light on the salient characteristics of the businesses those took part in this survey in respect to their legal status, any change in the legal status of the business, their business sectors and annual revenues, and the number of employees working for a business.

**Figure 4.1: Legal Status**



**Table 4.1: Legal Status**

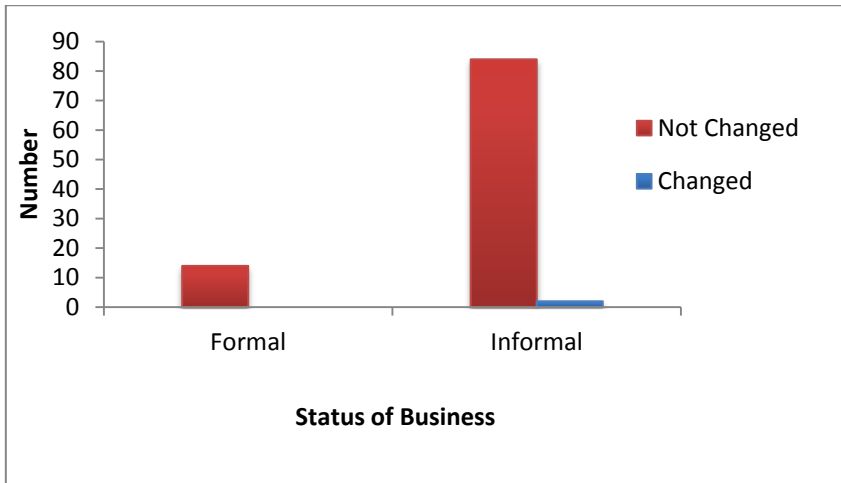
	Survey Result (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Sole proprietorship	82	12	70	86	81
Partnership	8	1	7	7	8
Family Based	10	1	9	7	10



Sole proprietorship was the most common legal status (82 respondents). Family based collective ownerships were the second most favoured legal status practiced by 10 respondents. Eight respondents were working as partnerships.

One of the interesting things about these enterprises is that these small businesses were never incorporated into limited liability companies. As a consequence, they failed to exploit their full potential. It is also interesting that in this study sample, formal businesses had a tendency to favour one man shows slightly more than their informal counterparts. If we want to unleash the full potential of Pakistan’s economy, we would have to promote incorporation of successful small businesses into limited liability corporations.

**Figure 4.2: Change in Legal Status**

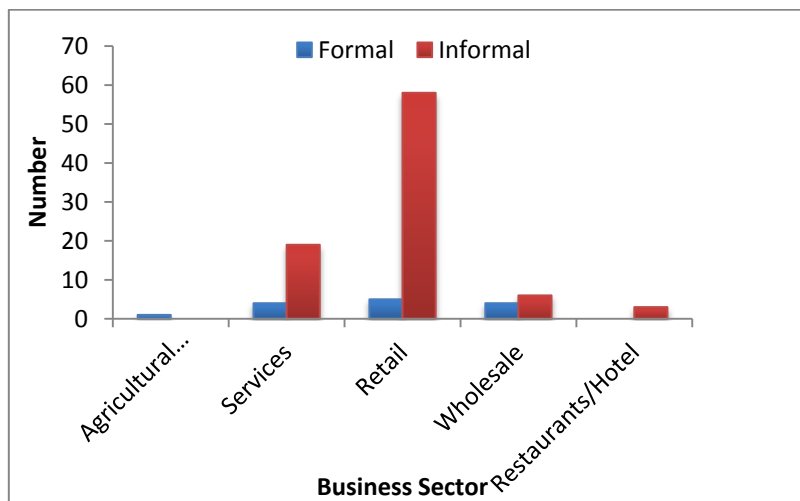


**Table 4.2: Changes in Legal Status**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Did not Changes	98	14	84	100	98
Changed	2	0	2	0	2

Only two businesses have changed their status while remaining within the informal sector and we did not find any concrete evidence of formal businesses slipping into informal sector and vice a versa.

**Figure 4.3: Business Category**



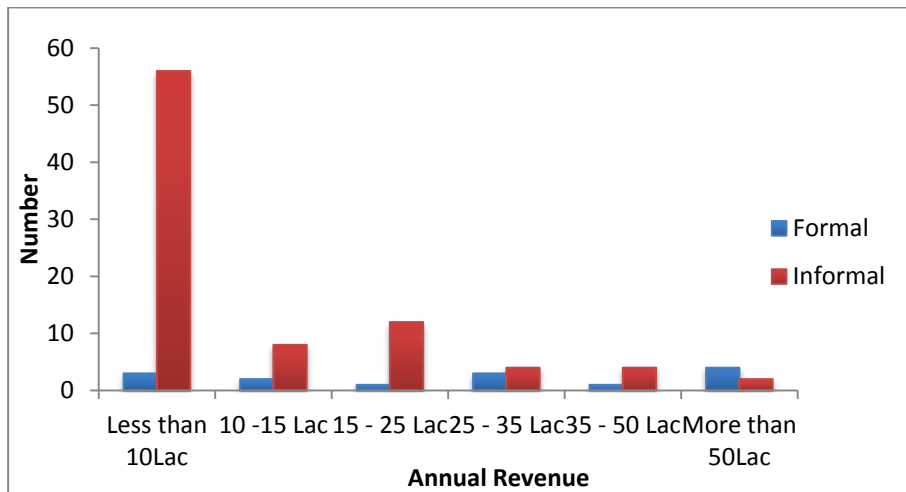
**Table 4.3: Business Category**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Agricultural Supplies	1	1	0	7	0
Services	23	4	19	29	22
Retail	63	5	58	36	67
Wholesale	10	4	6	29	7
Restaurants/Hotel	3	0	3	0	3

Among the respondents 63 businesses fell in retail category, 23 in services, ten in whole sales, while three in restaurant/hotel sector. Category wise, in formal, retail sector is dominant (36 percent) followed by wholesales, services sector (29 percent each) and agricultural supplies (7 percent). Among informal sector, retail sector (67 percent) is lagged by services (22 percent), wholesales (7 percent) and restaurants/hotels (3 percent)

A reasonable number of wholesale businesses get them registered with Federal Bureau of Revenue (FBR), while majority in retail sector prefer to remain in informal sector.

**Figure 4.4: Annual Revenue (In PKR)**



**Table 4.4: Annual Revenue (In PKR)**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
1Lac= 100K					
Less than 10Lac	59	3	56	21	65
10Lac to 15Lac	10	2	8	14	9
15Lac to 25Lac	13	1	12	7	14
25Lac to 35Lac	7	3	4	21	5
35Lac to 50Lac	5	1	4	7	5
More than 50Lac	6	4	2	29	2

In terms of annual revenue, 59 businesses had their gross sales less than one million per year. Ten businesses recorded sales between 1.5 and 2.5 million rupees, ten between 1 and 1.5

million. Five businesses generated revenue between 3.5 to 5 million rupees, and six businesses above 5 million rupees per year.

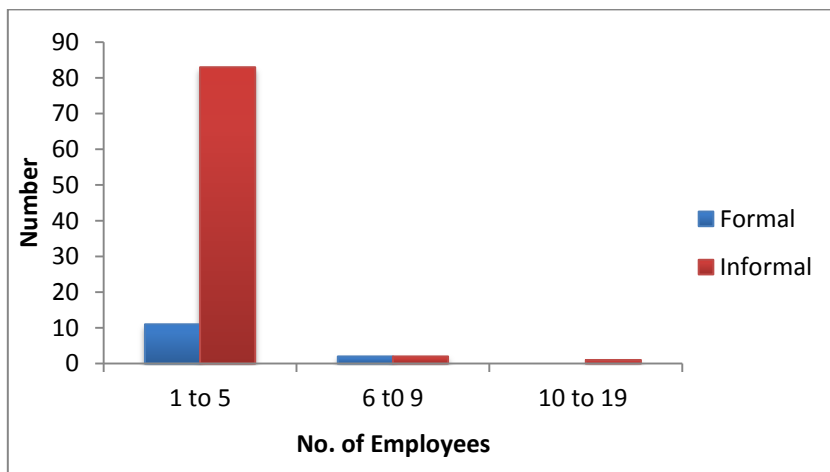
29 percent of the formal businesses are falling in more than 5 million per annum revenue category, while only two percent of the informal businesses are in the same category. Most of the formal businesses (57 percent) generated 2.5 million rupee, whereas most of the informal businesses (65 percent) recorded revenues less than one million rupees per year. In terms of annual revenues formal businesses fared better. Most of the formal businesses had their annual sales more than 1.5 million rupees per month, as compared to the most of the informal businesses those were selling less than one million rupees per month.

Writing on the same topic in the context of India, Dr. P.D. Kaushik has observed that the lowest earners among the extra-legal earned at least 49 percent more than the legal wage in Delhi.<sup>28</sup> This also holds true for Sharaqpur, where street hawkers told us that they were earning something like PKR15, 000/month. This was 50 percent more than minimum legal wage at the time of survey in Sharaqpur.

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<sup>28</sup> Kaushik, P.D. "Formal & Informal Entrepreneurship", Liberty Institute. Delhi, 2013, p.122

**Figure 4.5: Number of Employees**



**Table 4.5: Number of Employees**

	Survey Results (In Number)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
One to Five	94	11	83	79	97
Six to Nine	4	2	2	14	2
10 to 19	1	0	1	0	1

In terms of number of employees, 94 businesses have less than five employees, four have six to nine employees, but only one business has more than ten employees.

Almost 97 percent of the informal businesses employ less than five people, two percent informal enterprises have more than six but less than nine and one percent have more than ten

employees. In the formal sector 14 percent of the businesses have six to nine employees.

We can say that informal sector created most of the jobs in our study population while the average number of employees was high in a formal business.

### **Conclusion:**

Both formal and informal businesses preferred to remain a sole proprietorship and converting the business from informal to formal is not happening at a remarkable speed. The ratio of formal and informal businesses changes in different sectors. Most of the formal businesses are in wholesale and service sector, while most of the informal businesses opt for serving the end consumer. Formal businesses generally earn larger revenues than informal firms; however some informal businesses earn as good as formals. If per business job creation is concerned, formal businesses create more jobs per business. However, informal businesses employ more people due to their sheer number of occurrence.

### ***Case Study: The House always wins***

Mr. Sheikh, who is a local shopkeeper and an active political worker, told during the survey that two policemen came to his enterprise with his arrest warrants. Since he was an influential person, he somehow convinced the policemen to let him present himself to the court without getting arrested. When he reached the court he asked the concerned official about the charges against him. He was told that a magistrate found him selling merchandises packed in black polythene bags, and it was against the law. He told the official that all the bags he used, he purchased from the store next door. And even his supplier never supplied black polythene bags. The court official gave him two options:

1. Pay the minimum fine for the alleged crime, which was PKR 1000.
2. Challenge the observation of the magistrate in the same court.

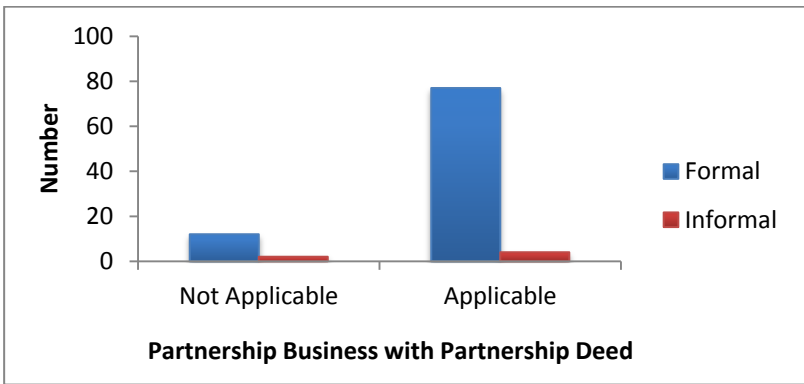
It did not take him more than a few seconds to understand that paying Pakistani Rupees 1,000 was more economical than suing against a regulator. So, he paid fine for a crime which he believes he did not commit.



## 5. Business Process Dexterousness

Just positive and negative externalities are not enough to survive in today's business life. The skills and internal policies of the entrepreneur also matter. Following are the results of the survey in regard to business process dexterousness of the entrepreneurs in formal and informal sector.

**Figure 5.1: Partnership Business (with Partnership Deed)**



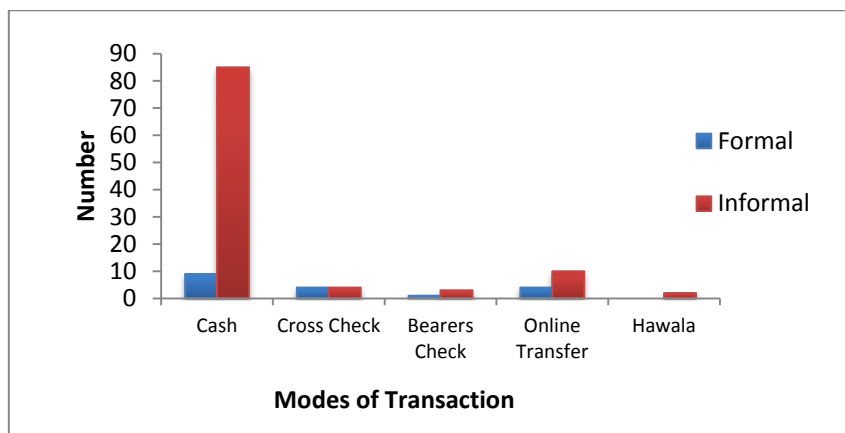
**Table 5.1: Partnership Business with Partnership Deed**

	Survey Results (In Number)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
No or Not Applicable	89	12	77	86	90
Have	6	2	4	14	5

Among the 18 businesses which are operating as partnerships or family based ownerships, only six have a written partnership deed. There are only two partnership businesses in formal sector

and both of these firms have partnership deeds. On the other hand, four out of the six partnership business in informal sector have the partnership deeds. This situation points towards relatively high emphasis on good business practices in formal sector. It should be remembered that in Pakistan *de facto* status of partnership does not qualify a business to be called or treated as partnership, to be a partnership it must have a written partnership deed between partners.

**Figure 5.2: Mode of Transactions**



**Table 5.2: Mode of Business Transactions**

	Survey Results (In Number)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Cash	94	9	85	64	99
Cross Check	8	4	4	29	5
Bearers Check	4	1	3	7	3
Online Transfer	14	4	10	29	12
<i>Hawala</i>	2	0	2	0	2

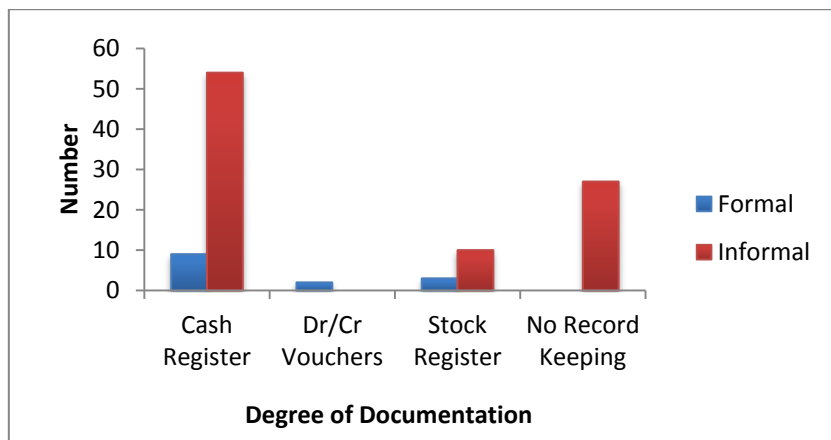
According to the respondents, currency notes are the most prevalent mode of transaction, 94 respondents deal in cash, 14 use online transfers of money. Eight businesses use cross checks, four use open checks, while hawala is almost obsolete as only two respondents use it for transaction. However, Federal Bureau of Revenue estimated that Pakistani Rupees 4.14 trillion were circulated through hawala circular remittances. They calculated this amount with the help of 0.3 percent withholding tax deductions, which were levied on cash withdrawals greater than Pakistani rupees 25,000. Hence they collected 12 billion rupees in the year 2010.<sup>29</sup>

There was a significant difference between the preference of and comfort level with bank related transaction between the formal and informal sector. Where 29 percent of the formal businesses

<sup>29</sup> Dawn. Karachi, 18<sup>th</sup> September, 2011, "Informal Economy: Guestimates." [URL accessed on 12<sup>th</sup> August, 2014: <http://www.dawn.com/news/659968/comment-and-analysis-informal-economy-guesstimates>]

reported using cross checks, only five percent of the informal enterprises were using these. Seven percent of the formal enterprises said that they use open/bearer's check as compared to only three percent of the informal enterprises. Informal sector adopted online transfer of money more than checks (both bearer's and crossed) 12 percent were using it as compared to 29 percent in formal sector. Both of the businesses which used *hawala*— are informal. This reminds us of the thesis of Dr. Hernando De Soto who argued that informal businesses give rise to illegal parallel money in his book "The Other Path."

**Figure 5.3: Degree of Documentation**



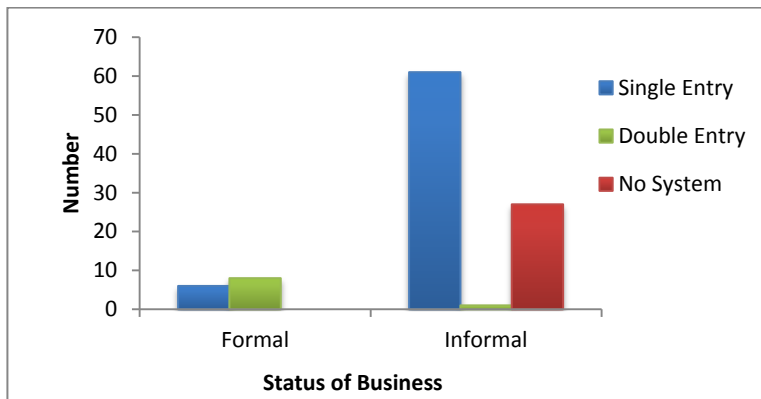
**Table 5.3: Degree of Documentation**

	Survey Results (In Numbers)			Survey Results (In percentage)	
	Overall	Formal	Informal	Formal	Informal
Cash Register	63	9	54	64	63
Dr/Cr Vouchers	2	2	0	14	0
Stock Register	13	3	10	21	12
No Record Keeping	27	0	27	0	31

Good record keeping is an essence of good business practices. For record keeping 63 respondents use some kind of a cash register. Two of them also use debit/credit vouchers, and 13 respondents use stock registers to track their inventory. However, 27 businesses do not maintain any sort of written record.

All the businesses in informal sector do not maintain any written record. This slackness in record keeping reduces the chances of success of any bank loans applications as they tend to rely on documented history of the enterprise. We do not see any causal relation, but ignorance with record keeping and state of the art business skills may have been a reason for lack of incorporation in local businesses. This may have hindered their growth beyond a certain level.

**Figure 5.4: Book Keeping System**



**Table 5.4: Book Keeping System**

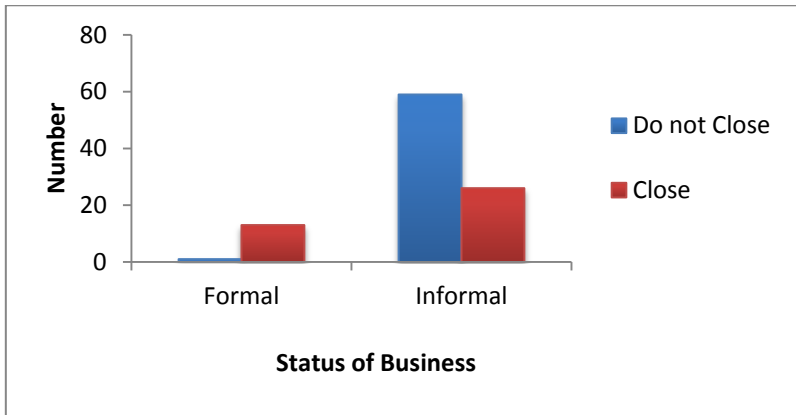
	Survey Results (In Numbers)			Survey Results (In percentage)	
	Overall	Formal	Informal	Formal	Informal
Single Entry	67	6	61	43	71
Double Entry	9	8	1	57	1
No System	27	0	27	0	31

Further for record keeping, nine of the respondents used double entry system of book keeping. As compared to 67 who were

comfortable with single entry system. However, 27 did not follow any system of book keeping.

In the formal sector, 57 percent of the businesses used double entry system; whereas, in informal sector, only one percent used it. Being oblivious of double entry system not only put the informal businesses in a difficulty to track their business performance, but put them at unease while dealing with banks and other financial institutes, and tax authorities those conventionally only use double entry system.

**Figure 5.5: Book Closing (Once a Year)**



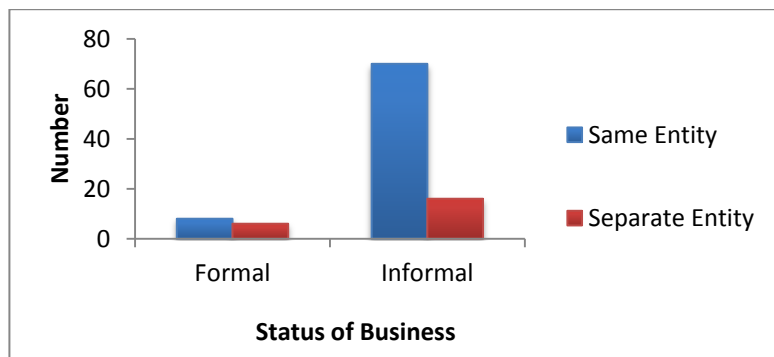
**Table 5.5: Book Closing (Once a Year)**

	Survey Results (In Numbers)			Survey Results (In percentage)	
	Overall	Formal	Informal	Formal	Informal
Don't Close	60	1	59	7	69
Close	39	13	26	93	30

To assess the actual performance of a business closing its books periodically can never be over emphasized. But only 39 businesses closed their books at least once a year to assess their performance, while 60 do not close their books.

Most of the businesses in the informal sector do not close books, that is, 69 percent as compared to only 7 per cent business in the formal sector. But how do they know how their business is going? They used various rules of thumb. One way to assess profit loss is to count how many people owe them money against how many people they owe money to. Another approach is to look at the stock and if the shop is filled with stuff more than last year, the business is considered in profit.

**Figure 5.6: Business as a Separate Entity**



**Table 5.6: Business as a Separate Entity**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Same Entity	78	8	70	57	81
Separate Entity	22	6	16	43	19



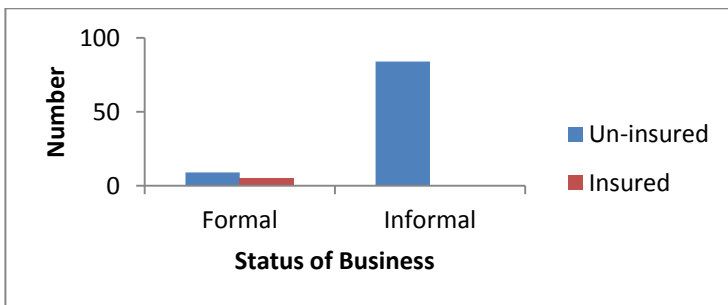
Good accounting practices stress on treating the business as separate entity instead of mixing the personal finances of the entrepreneur with his business finances.

Owners of 22 businesses consider their businesses as a separate entity, whereas 78 do not separate their personal finances from their business finances.

When we evaluate formal businesses on their practice of treating the business as a separate entity, they perform visibly better than the informal i.e. 43 percent of formal businesses practice separate entity concept, whereas only 19 percent of the informal enterprises do so. Still this 43 percent is not a very remarkable ratio, and since formal businesses have to report their income during filing tax return, such practices make their book keepings less reliable.

Actually, informal businesses do not have a choice; the reader will find elsewhere in this study that a dominant majority of informal businesses had annual revenue less than one million rupees. Hence, informal entrepreneurs are forced to mix their personal and business finances from time to time, as a matter of survival, because they earn very little.

**Figure 5.7: Insurance of Business**

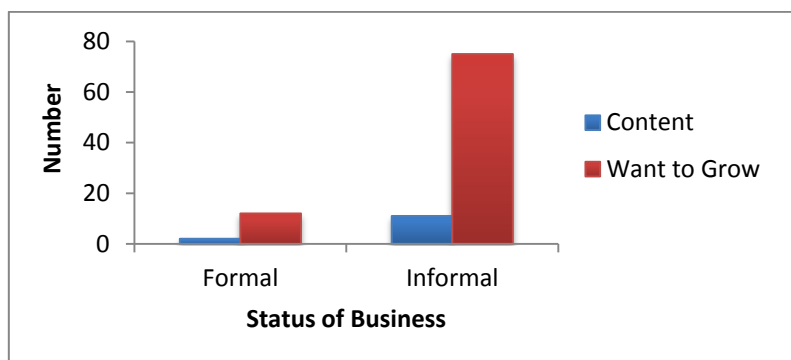


**Table 5.7: Insurance of Business**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Un-insured	93	9	84	64	98
Insured	5	5	0	36	0

Businesses face numerous types of risks, and to manage these risks they buy insurance. But in our sample of one hundred respondents, 93 businesses have no insurance cover against an unforeseen event, as compared the five businesses which are insured. The respondents who insured the businesses belonged to formal sector (36 percent of formal enterprises). It is important to note that only formal businesses got them insured.

**Figure 5.8: Attitude toward Business Growth**



**Table 5.8: Attitude towards Business Growth**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Content	13	2	11	14	13
Want to Grow	87	12	75	86	87

Contrary to what is stereotyped about the small conventional businessmen in Pakistan that 'they do not want to grow.' Majority of the small businesses 'wants to grow' from their current status; as compared to 13 percent minority those are content with their current status.

The ratio was almost similar in the formal and the informal sector.

### **Conclusion:**

Formal businesses are more comfortable with paperwork, than informal enterprises. They are more comfortable with bank related transactions of money and are less apt to use cash or quasi cash negotiable instruments like a bearer's cheque than informal businesses. However informal businesses are also adopting the bank facilitated transactions. Formal businesses maintain a written record, while more than one fourth of the informal businesses do not maintain any written record. Majority of formal businesses use double-entry system of accounting, while negligible minority uses double-entry system in informal sector. Slightly less than half of formal businesses treat their businesses as a separate entity, but less than one-fifth of businesses in informal sector are doing the same. Where in formal sector more than one-third of the businesses insure them

against uncertainties, no informal business does so. However a typical business wants to grow in formal as well as informal sector. In short, formal businesses are managed better than informal businesses.

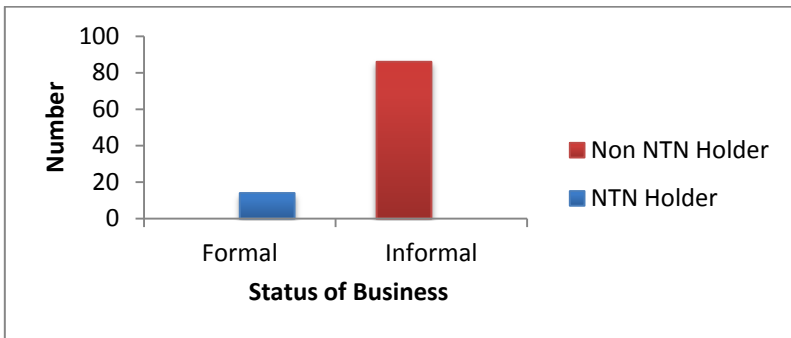
### **Case Study: Does faith influence an entrepreneur's decision making?**

British historian Niall Ferguson has endorsed the theory of Protestant Ethics in his book "Civilization." He seems to be of the view that faith can influence a person's work ethics and economic endeavours. On contrary Peruvian economist Hernando De Soto categorically rejects this theory and even has showed his disregard for it more than once in his book "The Mystery of Capital." What we find in our survey was nearer to Ferguson than De Soto. A number of respondents mentioned that they avoided taking loan from the bank because it was *unislamic*. A respondent told us that he was in the business of fabrics because it was a *sunah*. One respondent told us he did not count his profit-loss because it was against *tawakal*. While another respondent said that he calculated his profit/loss every year to assess the amount of *zakat* on his merchandise. When we asked a business man why he did not insure his business, he replied that one should have *tawakal* in God that nothing bad will happen with him. A number of shopkeepers mentioned interest as a factor for not applying for Prime Minister's Youth Loan Program. For a typical businessman in Sharaqpur, matters of faith are as important as matters of business.

## 6. Interaction with the Taxman

In Pakistan, Federal, Provincial and local governments collect taxes with the help of their revenue departments and contractors. We chose Federal Bureau of Revenue (FBR) to be used as a standard taxman. We also used having an FBR issued National Tax Number as a token of being a formal business.

**Figure 6.1: National Tax Number (NTN)**



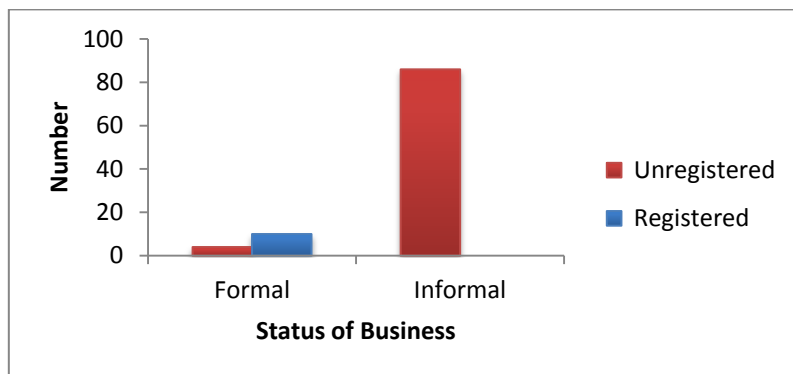
**Table 6.1: National Tax Number (NTN)**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Non NTN Holder	86	0	86	0	100
NTN Holder	14	14	0	100	0

14 businesses are income tax registered, whereas 86 are not.

We used having a National Tax Number (NTN) as a yardstick of being a formal business in this study. In this respect, 86 percent of the businesses in Sharaqpur fell in informal sector.

**Figure 6.2: Sales Tax Registration**



**Table 6.2: Sales Tax Registration**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
S.T Unregistered	90	4	86	29	100
S.T Registered	10	10	0	71	0

Ten businesses are sales tax registered, whereas 90 are not. All the businesses having a sales tax registration belonged to formal sector; they constituted 71 per cent of the formal sector.

Having a sales tax registered status gives businesses some benefits in terms of time value of money, as there is always a lag of few days between deductions of sales tax from the customer and paying it to FBR.

**Table 6.3: Tax withholding Agency**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Non-Tax Withholding Agent	99	13	86	93	100
Tax Withholding Agent	1	1	0	7	0

Out of the sample, only one respondent from the formal sector is the tax withholding agent. Having a status of tax withholding agent gives businesses right to deduct a percentage of its payments to be deposited to the FBR at a later stage as reclaimable tax withheld on behalf of payee. Hence, a tax withholding agent enjoys a free ride on the money of the taxpayer until it gets deposited to the national kitty.

**Table 6.4: Tax Payer Status**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Do Not file Tax Returns	84	1	83	7	97
File Tax Returns	11	11	0	79	0

Many NTN holders do not file their tax returns in Pakistan. However, eleven out of fourteen formal businesses file their tax returns, which meant that 79 percent of the formal businesses in Sharaqpur are active tax payers.

**Table 6.5: Tax Rebates**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Don't Receive Tax Rebates	95	11	85	79	99
Receive Tax Rebates	1	1	0	7	0

One business received tax rebates, which is a formal business; it made it seven percent of the formal sector. (We have used the term rebate for refund instead of exemption.)

To disincentivise the informal sector, FBR uses high ratios of withholding taxes at any step where informal and formal enterprises meet with other formal enterprises. Formal businesses have an opportunity to claim such withheld amounts if they exceed their tax liability at the time of filing their tax returns. However, for the informal businesses these taxes withheld exceeding their tax liability becomes a sunk cost, which they can never receive back.



**Conclusion:**

Most of the businesses were not registered with FBR. One in every seven businesses got it registered for National Tax Number. Most of the NTN registered businesses also received sales tax registration. Eighty percent of the formal businesses filed their tax returns. Only one out of fourteen of the registered businesses received a refund. Businesses cited different reasons for not getting registered with FBR, including low income, difficult to meet reporting requirements and harassment by the officials.

***Case Study: Withholding tax: a loss—loss game.***

In an attempt to increase National Tax Number (NTN) registrations, government has installed a snare of withholding tax (WHT) at every nook and corner. Citizens and businesses have to pay this tax while paying their utility bills, while withdrawing cash from their bank accounts, while receiving interest on their savings, and while doing business to business transactions. Theoretically, an NTN holder can claim this WHT at the time of filing his tax returns. The ratios of WHT are so high that NTN holders expect from their tax consultants to take their fees out of the refunds, and still return them back the little something which was extra to their tax liability and consultant's fee.

Informal businesses become a special victim to WHT. Many of them earn less than the minimum tax bracket, by not having an NTN number they do not have a choice to receive their tax refunds. WHT discourages such businesses from using the services of banks. When we asked why businesses depended on cash based transactions, which were very risky, instead of using bank, a participant of the focus group meeting said that banks take more and give less. (Conventionally, in Pakistan banks do

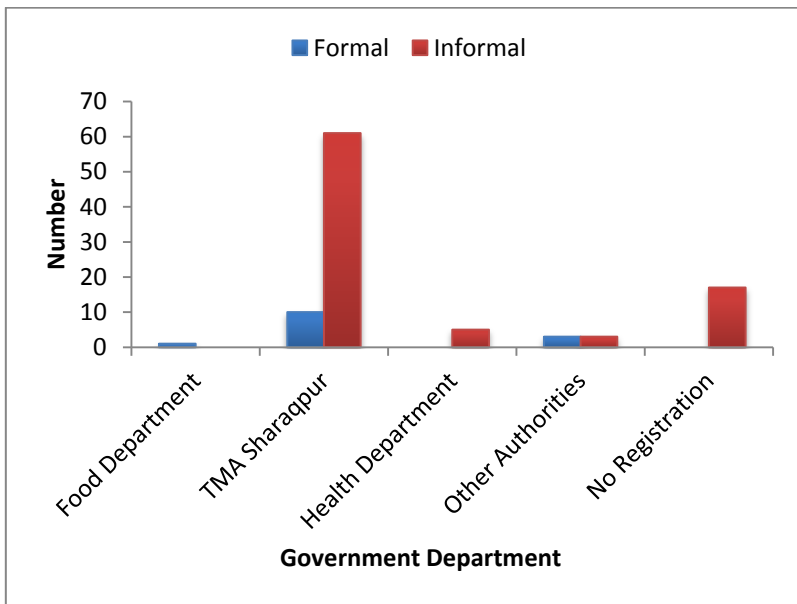
not pay interest on current/checking accounts, but WHT is deducted on cash withdrawals.)

Apparently, WHT on cash withdrawals should discourage the use of cash. But on the ground it creates a parallel banking system based on different variants of thrift credit systems those are cash based and do not deduct WHT. Society pays the price as shift towards a cash based economy also encourages street crimes and shop robberies. FBR itself suffers when Tax Withholding Agents/Businesses fail to deposit the tax collected from other parties to the state coffers. A false sense of national responsibility also arises among the people those have means to come into the tax net but still they prefer to remain unregistered because they believe they are already paying their fair share of taxes as WHT.

## 7. Interaction with the Government

Businesses have to interact with different departments of the government on regular basis for a number of reasons like obtaining licenses, getting inspections and meeting the officials on law and order situations. This section examines such interactions.

**Figure 7.1: Registration with Government Department**



**Table 7.1: Registration with Government Department**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Food Department	1	1	0	7	0
TMA Sharaqpur	71	10	61	71	71
Health Department	5	0	5	0	6
Other Authorities	6	3	3	21	3
No Registration	17	0	17	0	20

As P.D. Kaushik noted in his study that most preferred registration among the shopkeepers was with Municipal Corporation Delhi (MCD), while fewer businessmen had registered them for taxes like, sales tax<sup>30</sup>. A similar trend was observed in Sharaqpur where most of the businesses were registered with Tehsil Municipal Authority Sharaqpur (TMA Sharaqpur.)

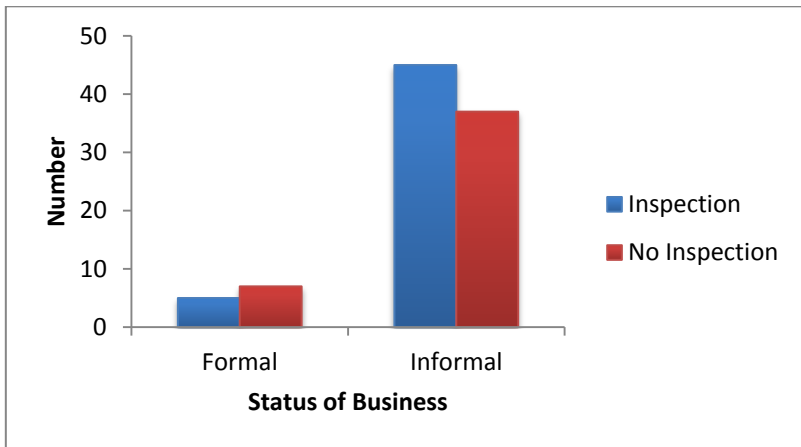
71 businesses got licenses from Tehsil Municipal Administration (TMA) Sharaqpur, the ratio was same for formal and informal businesses. Five businesses were licensed from the Health department, all were informal. Six from other authorities, and one from food department, 21 percent of the formal and 3 percent of informal businesses were licensed by other authorities. The only business registered by food department was in formal

<sup>30</sup> Kaushik, P.D. "Formal & Informal Entrepreneurship" Liberty Institute. Delhi, 2013, p.82

sector. As much as 17 businesses were not registered with any department of government, these businesses were all part of informal sector. While one business did not like responding to this enquiry.

In terms of percentage, 99 percent of the formal businesses were registered with one of the government authority as compared to 80 percent of the informal enterprises.

**Figure 7.2: Government Inspection of the premises**

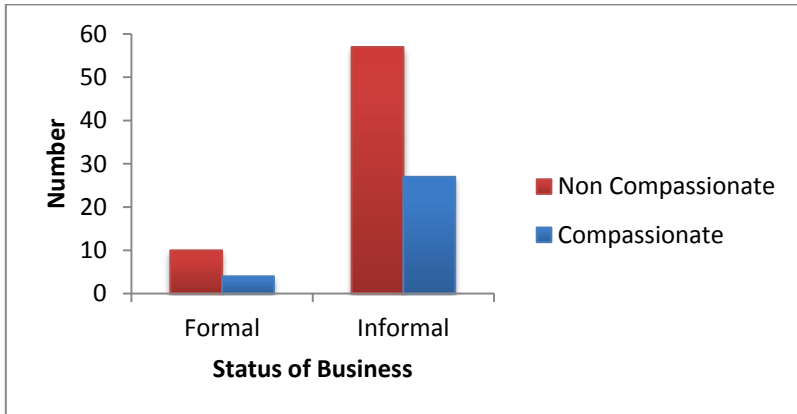


**Table 7.2: Government Inspection of the premises**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Received a visit	50	5	45	36	52
Didn't Receive a visit	44	7	37	50	43

Half of the respondents, i.e. fifty businesses received an inspector from a government department within last one year. Interactions included price checking, fine, warning, fee collection, bribe, threatening, sample collection, and completely serene routine inspection.

The informal businesses were more prone to receive an inspector, magistrate or government authority at their business premises (52 percent as compared to 36 percent of the formal businesses).As a result, the informal businesses are more prone to harassments, fine or mistreatment by an unscrupulous official, however mostly such visits do not end up in persecution of entrepreneurs.

**Figure 7.3: Perception of Authorities among Businessmen****Table 7.3: Perception of Authorities among Businessmen**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Non Compassionate	67	10	57	71	66
Compassionate	31	4	27	29	31

Most of the respondents (67 percent) found that the authorities are not compassionate with the businessmen of their elk. Still a significant number (31 percent) believed that they were compassionate with them.

Formal businesses received less visits by the authorities, but they perceived them as less considerate more that the business in the informal sector. On the other hand, 31 percent in the informal sector said that government authorities as compassionate in contrast to 29 percent in the formal sector.

Conclusion:

Contrary to avoiding registration with FBR, most of the businesses got them registered with local municipality; Tehsil Municipal Administration (TMA) Sharaqpur. Each of the formal businesses has registered itself with at least one government department, other than FBR. The Informal businesses were inspected by the authorities more than the formal businesses. More than two third of businesses have a perception of state authorities as non-compassionate. Formal businesses have more negative perception of authorities than the informal businesses.

***Case Study: How fair are Fair Price Markets?***

As an image building attempt District Government Sheikhpura announces the price lists of food items on daily basis through District Market Committee. Tehsil Municipal Administration (TMA) Sharaqpur enforces this list by declaring a few business streets of the city as Fair Price Markets (FPM.) In a Fair Price Market every grocery seller has to display a state provided fresh rate list. And charging more than this list is an offence.

We took views from a few shopkeepers about this practice. It appears that those shopkeepers who were not in the business of food items tend to support this price control. On contrary shopkeepers in the business of food oppose it.

Officials of local, district, and provincial governments ensure the FPM system by applying various strategies. They advertise complaint registration numbers, they use mystery shoppers, their inspectors and price magistrates keep raiding these markets along with surprise visits of government higher-ups.

As a result, the shopkeepers have devised a number of survival mechanisms to hoodwink the system. One fruit seller opined that no one sells at the price dictated by the government. And the



price lists, and price cards provided by the state were serving no purpose, but another way of tax collection. He told that the fruit sellers started selling two qualities of the fruits, a relatively low quality for the customers those insist on purchasing at list price and a better one for those who can pay a premium price.

Another shopkeeper, who runs general store, told that to avoid getting entrapped by mystery shoppers of the government he tries to sell the strangers at a list price, and to his regular customers, or the people in his acquaintance at a higher price.

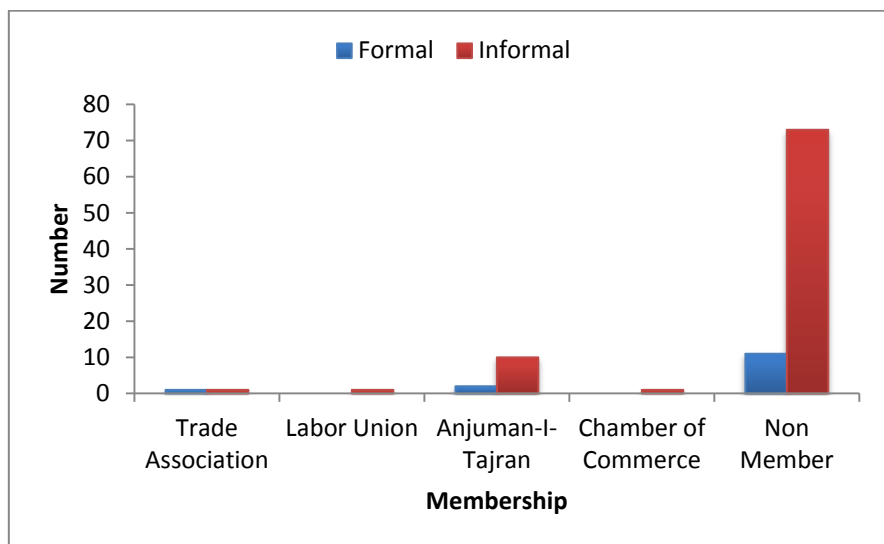
Still another respondent, a garment seller and not subject to price control himself, said that at times when rates of fruits and vegetables fall in the wholesale market. The retailers use the official rate list as an argument in favour of not dropping the price for the end consumer.

**Fair price markets are not very fair, because they are based on coercion on the part of the government and deception on the part of the seller. And though they provide good will to the government, actual relief does not reach to the public. And how can these markets be fair, when they are not based on one of the key components of fairness; the mutual consent.**

## 8. Group Activism

For businesses things always do not go smoothly while dealing with the state and its representatives. Sometimes they need to organize, and raise their voice. This section tries to measure a membership status of businesses with a group of traders, its methods of protesting against an authority and if it receives any help from a political person or party.

**Figure 8.1: Membership Status**



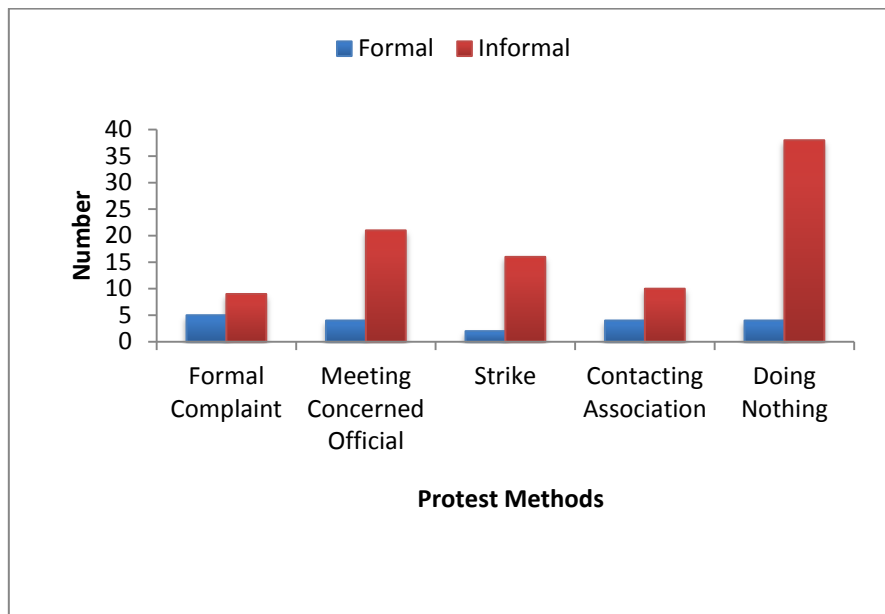
**Table 8.1: Membership Status**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Trade Association	2	1	1	7	1
Labor Union	1	0	1	0	1
<i>Anjuman-e Tajran</i>	12	2	10	14	12
Chamber of Commerce	1	0	1	0	1
Non Member	84	11	73	79	85

According to the survey, 84 businesses are not members of any association. However, twelve are members of *anjuman-e tajran*,. Two are members of a trade association. One business mentioned it as a member of a labor union. One business also claims to be part of a chamber of commerce. The Formal businesses have a slightly more tendency to be a member of some association. However, it can be said that majority of businesses both in the formal and in the informal sector do not subscribe to any membership of an association. The *anjumanha-e tajran* are fragmented in Sharaqpur, and usually they are not legal bodies. A precedent exists in the struggle of rickshaw drivers. In a report on the plight of rickshaw drivers the writer emphasized that unregistered status of trade unions was a factor for the failure of the unions in presenting their point of view to the government officials. And due to their lack of being a legal body, these unions

even failed to implement the concessions which they negotiated with different government departments.<sup>31</sup>

**Figure 8.2: Method to Protest**



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<sup>31</sup> Gabol, Imran, "An Informal Sector of its kind." Dawn. Karachi, 6th February, 2014. [URL accessed on 27<sup>th</sup> July, 2014: <http://www.dawn.com/news/1085216>]

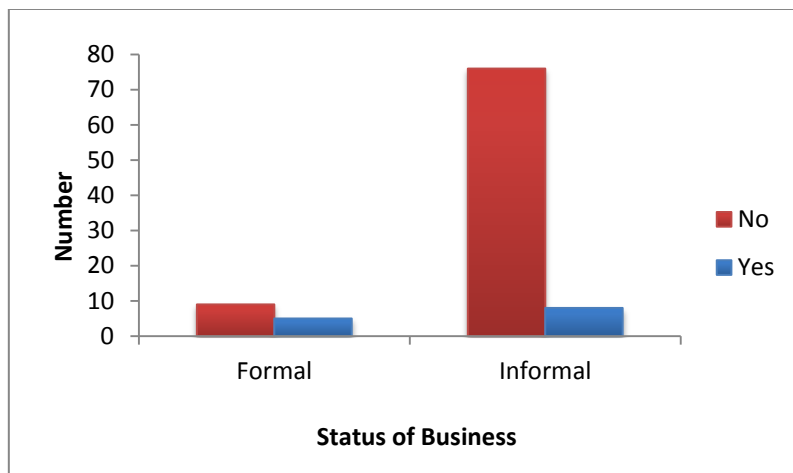
**Table 8.2: Method to Protest**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Formal Complaint	14	5	9	36	10
Meeting Concerned Official	25	4	21	29	24
Strike	18	2	16	14	19
Contacting <i>Anjuman-e Tajran</i>	14	4	10	29	12
Doing Nothing	42	4	38	29	44

In case of a complaint from a government office, twenty five respondents talked to the concerned official directly, 42 do nothing, and 14 respondents preferred to register a formal complaint. Fourteen asked for the help of trade association or *anjuman-e tajran*. Eighteen respondents favoured going on strike as a method of protest.

The ratio of registering a formal complaint is more in the formal sector (36 percent) as compared to the informal sector (10 percent). Formal businesses also have a lesser inclination towards calling on a strike (14 percent as compared to 19 percent in the informal sector). Formal businesses also contacted their association more often than the informal businesses, to solve their problems (29 percent as compared to 12 percent in the informal sector). They were more vocal as well: only 29 percent of them opted for doing nothing if they had resentment as compared to 44 percent of the informal enterprises those chose the same path.

**Figure 8.3: Help given by Political Party/Person against Government**



**Table 8.3: Help given by Political Party/Person against Government**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
No	85	9	76	64	88
Yes	13	5	8	36	9

Thirteen respondents acknowledged receiving help of a political person or party against a government servant, 41 respondents did not. Two respondents did not answer this query.

Apparently formal businesses are more comfortable in dealing with politicians as 36 percent of them received help form a

political party or person as compared to nine percent in the informal sector.

### **Conclusion**

Most of the businesses are not part of an organized group. Whereas, those who are members of a group are generally member of an *anjuman-e tajran* (trade association). While expressing their grudges, formal businesses were far more likely to launch a formal complaint than the informal businesses. They were also more likely to contact *anjuman-e tajran*, than informal businesses. Formal businesses are four times more likely to ask for the help of a political person or party against a government authority, they also called on strike less, but protested more often than the informal businesses. Whereas, a significant number of the informal businesses chose to be a silent victim of the misgivings of authorities.

### **Case Study: Lacking Leisure Time: Dilemma of Small City Entrepreneurs.**

Like many small towns of Pakistan, businessmen in Sharaqpur are caught up in a classical Prisoners' Dilemma: they do not have a weekly holiday. On February 23, 1997 weekly holiday was changed from Friday to Sunday. However, many business centres in small and even major cities, like Gujranwala and Faisalabad, generally decided to carry on the weekly holiday on Friday.

The dilemma started at an unknown time when a few ambitious traders opened their shops on Friday. This put pressure on others to open their shops as well, to compete properly in the market. As a consequence, a number of the shopkeepers have seven days working week. They even work while having physical ailments. One of the entrepreneur in the informal sector even told that he

had a toothache since last few months, but he could not find the time to see the dentist.

The West Pakistan Shops and Establishments Ordinance, 1969 empowers the authorities of labour department to enforce a weekly holiday in many cases. A respondent told that officials of labour department do visit their shops on Fridays to address this issue, occasionally. But their contribution is limited to harassing the shopkeepers and extracting bribes.

At least one of the six *Anjumanha-e Tajran* , The Garment Association Sharaqpur has voluntarily imposed on its members to keep their establishments closed on Friday. And the members act upon this. Other *Anjumans* need to follow the lead to increase the work life balance for their members.

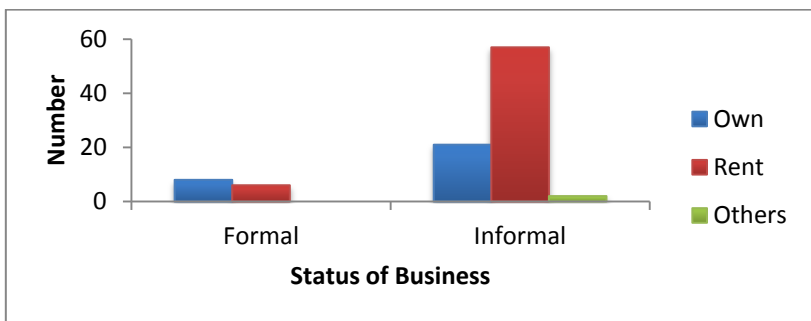
The failure of the coercive measures of the labour department officials, and success of the voluntary understandings of the members of Garment Association in implementing the same rule, proves that self-regulatory initiatives taken by ordinary citizens are more effective than state imposed authoritarian measures.



## 9. Property Rights and Contract Enforcement

Property not only stores the sweat of an entrepreneur, but it comes handy while applying for a business loan i.e. as collateral. The appreciation in the price of property also becomes a source of increase in the wealth of the entrepreneur. Furthermore, real life business is filled with broken promises and misunderstandings and to ensure the sanctity of an agreement, businessmen need a contract enforcement agent to resolve the dispute. This section scans the businesses on the bases of property rights and contract enforcement.

**Figure 9.1: Ownership of Business Premises**



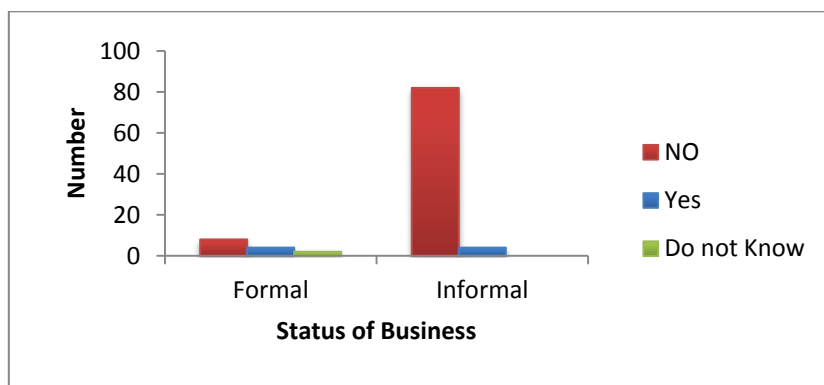
**Table 9.1: Ownership of Business Premises**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Own	29	8	21	57	24
Rent	63	6	57	43	66
Others	2	0	2	0	2

Ten respondents owned their business premises, while 63 operated out of rented property. Two businesses operated on shopping carts, bikes etc. without having a fixed space.

Most of the entrepreneurs (57 percent) in the formal sector own the business space as compared to entrepreneur in the informal sector (24 percent). Hence, formal businesses tended to enjoy better property rights as compared to informal businesses.

**Figure 9.2: Eligibility of Business as Collateral**



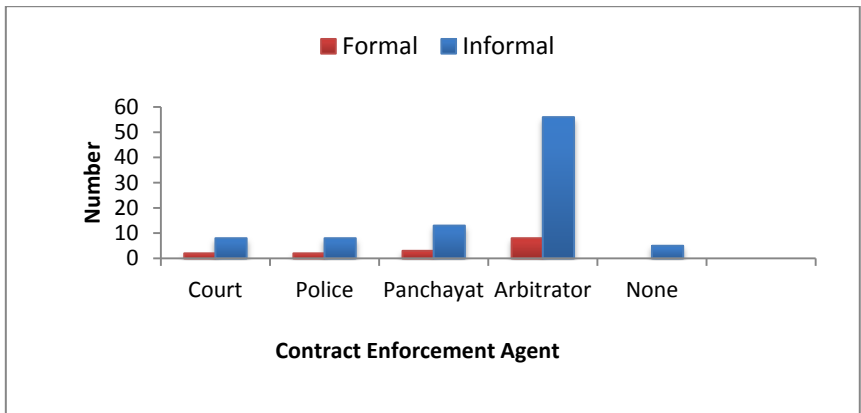
**Table 9.2: Eligibility of Business as Collateral**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
NO	90	8	82	57	95
Yes	8	4	4	29	5
Do not Know	2	2	0	14	0

Eight respondents believed that their businesses can be used as a guarantee in a court of law as compared to 90 respondents who believed that their businesses cannot be used as collateral. And two respondents mentioned they did not know.

Only 5 percent businesses in the informal sector are eligible as a guarantee, compared to 29 percent businesses in the formal sector. As Dr. Kaushik has maintained in his study of Formal and Informal Enterprises in Delhi, these businesses cannot use their virtual property or good-will as a guarantee in a court of law. However, they can use their land or real assets as a guarantee. Since more businesses have their own premises in formal sector, therefore formal entrepreneurs are more confident if their business can stand guarantee in a court of law.

**Figure 9.3: Preferable Contract Enforcement Agency**



**Table 9.3: Preferable Contract Enforcement Agency**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Court	10	2	8	14	9
Police	10	2	8	14	9
<i>Panchayat</i>	16	3	13	21	15
Arbitrator	64	8	56	57	65
None	5	0	5	0	6

Survey results indicate that the arbitrator enjoys the trust of businessmen with a landslide lead as 64 respondents chose him as the most effective contract enforcement agent. Only 16 respondents trusted *Panchayat* followed by police (10 respondents) and courts (10 respondents.)

The order of preference for a contract enforcement agent was not different for formal or informal enterprises. However, there is a relative weightage difference for both kinds of the enterprises. Formal sector trusted the institutional contract enforcement agents like *Panchayat*, police or court slightly more than informal sector. Extra-legal businesses preferred arbitrator slightly more than the formal sector did. Formal enterprises were also more optimistic about the justice system. All the formal business considered one of the contract enforcement agents effective as compared to few businesses in the informal sector (6 percent) that perceives none of the contract enforcement agent effective.

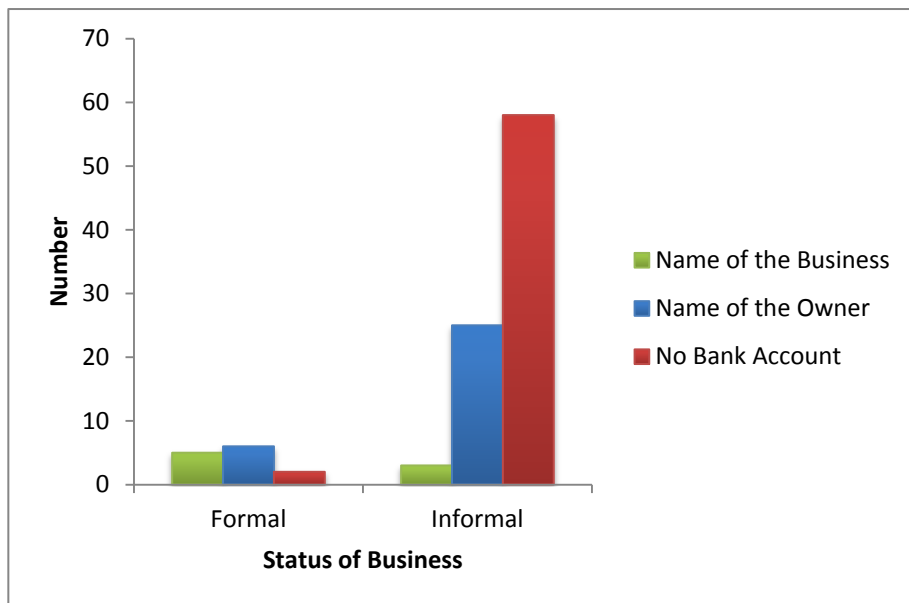
**Conclusion:**

Formal businesses were more than twice as likely to own their business premises as the informal enterprises, and most of them owned the business property. Most of the informal businesses operated out of rental property. Formal businesses were more confident, that their businesses can stand guarantee in a court of law, because of the real assets their businesses possessed in terms of property. Both the formal and the informal businesses considered arbitrator as a best contract enforcement agent. *Panchayat*, though it is an informal institution of contract enforcement, was favoured by one sixth of the respondents, far less than arbitrator. However, police and courts won the trust of even fewer businessmen, less than *panchayat*. The Formal businessmen trusted institutional or group contract enforcement agents like *panchayat*, police and courts more than the informal entrepreneurs those preferred individual arbitrators more. Just 20 percent people trusting state run justice system paints a question mark on the rule of law. We also asked a few businessmen about the reasons of not contacting police and courts. The avoidance to contact police was based on poor prosecution by police officers, and bribes, while for courts, years of legal procedure without yielding any results was not pragmatic for the businessmen. *Panchayats* were not considered because of *chowdrahat* (a mixture of vanity and nepotism among the adjudicators.)

## 10. Access to Finance:

Finance is to business like blood is to body. This section draws a comparison on preference for the source of the finance among the formal and informal businesses and their relationship with the bank.

**Figure 10.1: Title of the Bank Account**



**Table 10.1: Title of the Bank Account**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Name of the Business	8	5	3	36	3
Name of the Entrepreneur	31	6	25	43	29
No Bank Account	60	2	58	14	67

Survey results indicate that 60 businesses do not have any bank account. 31 businesses have bank accounts in the name of the owner. Only eight businesses open the business accounts with the title of their bank accounts in the name of the said business. There was a striking dissimilarity between the formal and informal sector when it came to preferences for having a bank account. Most of the informal businesses have no bank account (67 percent.) Yet a relatively small but significant percentage of formal businesses operate without bank accounts (14 percent). Whereas, 36 percent of the formal businesses opened bank accounts in the name of the businesses, only 3 percent of the informal businesses had their names as a title of their bank account.

Having name of the business as a title of the bank account increases the value of virtual property of a business, it makes it easier to file tax returns and facilitates in implementing separate entity concept, most of the informal businesses and a number of formal ones waste this opportunity by not having a separate bank account.

### **Case Study: Thrift Credit System (TCS)**

In the absence of access to the bank loan, thrift credit system provides for the working capital needs of the businessmen in local economy. In this system shopkeepers form a society whose members agree to contribute a fixed sum of money at periodic intervals of daily, weekly, fortnightly or monthly cash payments. This collection called “committee” is then given to one member to fulfil his immediate business needs. It is customary that the first committee goes to the organizer as a regard to his legwork which is needed to form a large pool of people with credit worthiness. The successive turns of the committee go to the members with a preference order set either by the roll of a dice, or mutual consensus of the members. A deviation called *Boliwali-Committee* (Auction based Committee) also exists in which members purchase the favourable turns of committee like first, or second in an auction to source working capital when they need it the most.

These societies are very popular in Sharaqpur, other than the formal and informal businessmen, office workers, house wives, and even school kids form thrift credit societies in their circle of acquaintances to purchase “rite of passage” items like a costly smart phone, first car, first house, or an expensive marriage ceremony.

One of the drawbacks of TCS is that these are almost always non-registered and unchartered by the central bank or any financial authority. And if a member, especially the organizer defaults during the course of a committee, rest of the members have to suffer a loss of money. However, because people tend to form societies only with the people they know on daily bases, such defaults are very rare. Another demerit is that people those have the last turn of a committee, receive a negative time value for money.



Conventional thrift credit societies usually do not charge or pay interest. But quoting an official of the Securities and Exchange Commission of Pakistan, Aazim related that in Karachi, networks of people were formed lately. Those lend each other at a high interest rate, thanks to the availability of free liquidity, which financial institutions and banks did not succeed in tapping into their systems.<sup>32</sup>

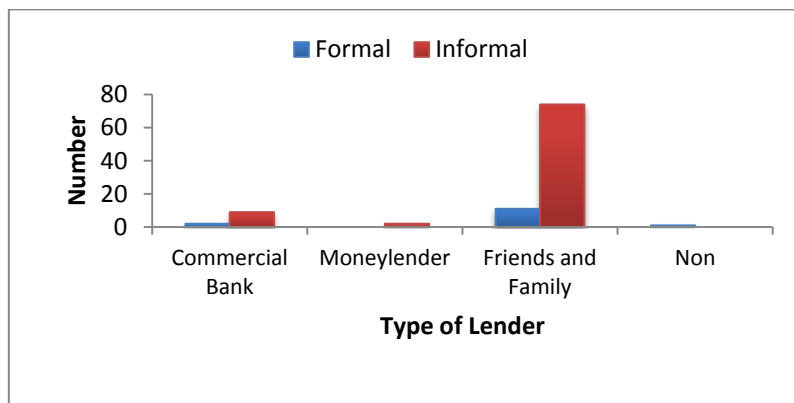
On a positive note, thrift credit societies promote good social values, like cooperation, pooling of resources, trust, and interdependence. This surly strengthens a good business ecosystem. While admiring committee system Dr. Amjad Saqib, a famous Pakistani expert on microfinance, has written, "Before importing external visions or models of progress and prosperity. We should understand the existing indigenous institutions, and our own strengths. Committee system is an extraction of local wisdom and experiments. After a few necessary additions, we can make it an important strategy to reach for the capital along with savings."<sup>33</sup>

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<sup>32</sup> Aazim, Mohiuddin, "Employing foot-loose capital in productive assets." Dawn. Karachi, 5<sup>th</sup> May, 2014. [URL accessed on 16<sup>th</sup> July, 2014: <http://www.dawn.com/news/1104187>]

<sup>33</sup> Saqib, Amjad, "*Ghurbat Aur Microcredit*," Ali printers and Publishers. Lahore, 2003, p.197 (Quotation Translated from Urdu.)

**Figure 10.2: First Choice for Borrowing Money**



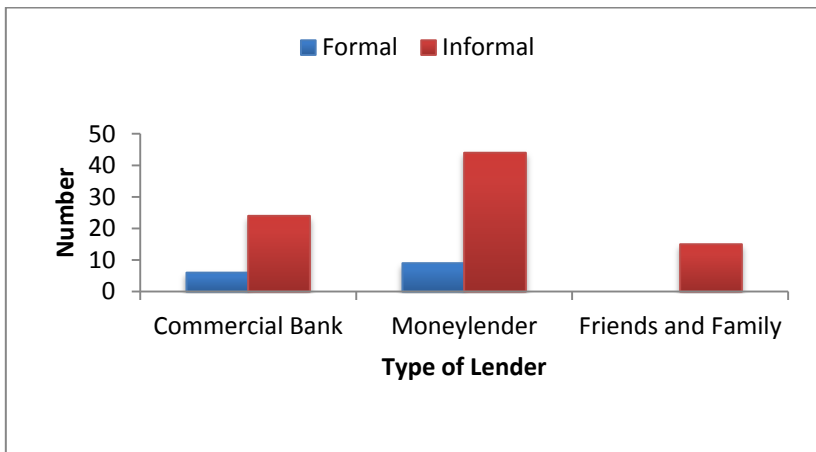
**Table 10.2: First Choice for Borrowing Money**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Commercial Bank	11	2	9	14	10
Moneylender	2	0	2	0	2
Friends and Family	85	11	74	79	86
Non	1	1	0	7	0

Majority of the respondents, that is 85 entrepreneurs, said that friends and family are the first choice to borrow money from. Followed by commercial bank which was selected by 11 respondents, and money lender who was selected by two respondents as lender of the first choice. Burki and Mohammad in their study also pointed out that friends and family were not one of the predictable sources of credit. And the burden of reciprocity associated with this source of credit made it

unattractive to the debtor.<sup>34</sup> Comparing the formal and the informal sector, fewer formal businesses relied on friends and family (79 percent as compared to 86 percent in the informal sector) and more on commercial bank (14 percent as compared to 10 percent in the informal sector). None of the formal business considered money lender as a favourite, while 2 percent of the informal businesses considered them as the first choice.

**Figure 10.3: Lender of the Last Resort**



<sup>34</sup> Burki, Hassan Bano and Mohammad, Shama, "Mobilizing Savings from the Urban Poor in Pakistan: An Initial Inquiry." Shore Bank International Ltd. Chicago (Branch Office Pakistan), January 2008 p.12

**Table 10.3: Lender of the Last Resort**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Commercial Bank	30	6	24	43	28
Moneylender	53	9	44	64	51
Friends and Family	15	0	15	0	17

Money lender is considered the lender of last resort by 53 respondents, commercial bank by 30 and friends and family by 15 respondents. It would be interesting to note here that Burki and Mohammad recorded that Money lenders usually charged 10 percent per month, and they preferred to take the money back in one instalment. They also reported variation in money lending in which money lender holds the property of the debtor for the period in which the debtor uses his money; the rental income etc. is taken by the lender instead of interest.<sup>35</sup> Such usage instead of interest arrangement is called *girvi* in Sharaqpur.

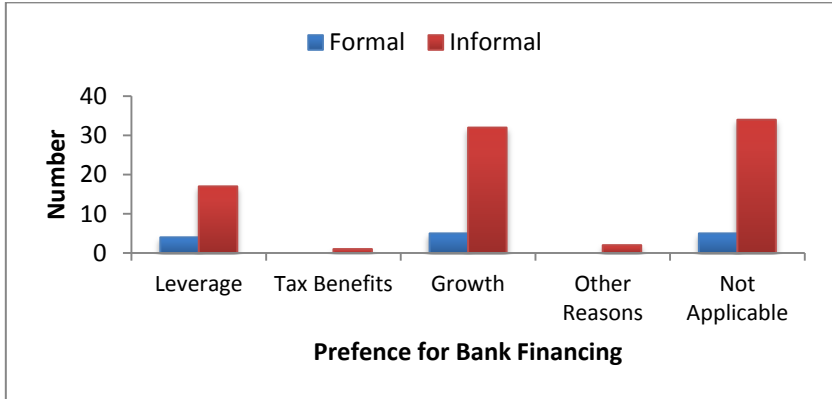
None of the formal businesses considered friends and family as lenders of the last resort, in contrast to 17 percent of the informal businesses. More of the formal businesses (64 percent) considered the moneylender, than the informal businesses, when they were desperate for funds. Among the informal businesses, 28 percent considered the commercial bank as lender of last

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<sup>35</sup> Burki, Hassan Bano and Mohammad, Shama, "Mobilizing Savings from the Urban Poor in Pakistan: An Initial Inquiry." Shore Bank International Ltd. Chicago (Branch Office Pakistan), January 2008 p.p 12-13

resort as compared to 43 percent in the informal businesses those contemplated the same.

**Figure 10.4: Reasons to Prefer Financing from Bank**



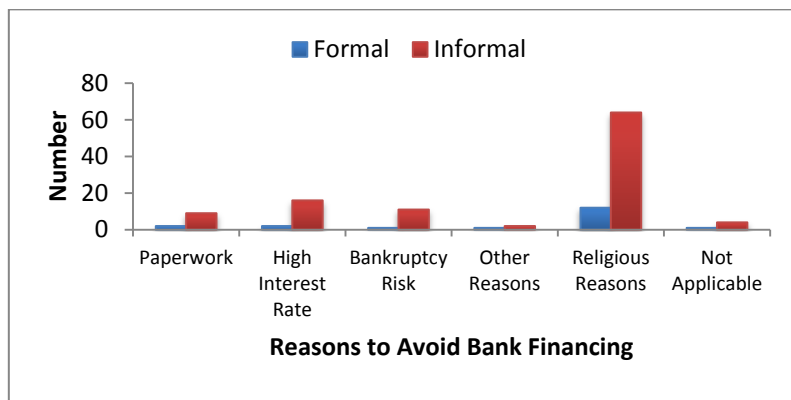
**Table 10.4: Reasons to Prefer Financing from Bank**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Leverage	21	4	17	29	20
Tax Benefits	1	0	1	0	1
Growth	37	5	32	36	37
Other Reasons	2	0	2	0	2
Not Applicable	39	5	34	36	40

Businesses preferred financing from the bank to support their growth (37 respondents). Leverage was also a significant reason considered by 21 participants. Two respondents had other reasons. Though one respondent found the financing from a

bank lucrative due to tax benefits. 39 respondents did not like financing from a bank at any cost. Results indicate that the ratios and order of preference is almost same for both of the types of businesses.

**Figure 10.5: Reasons to Avoid Financing from Bank**

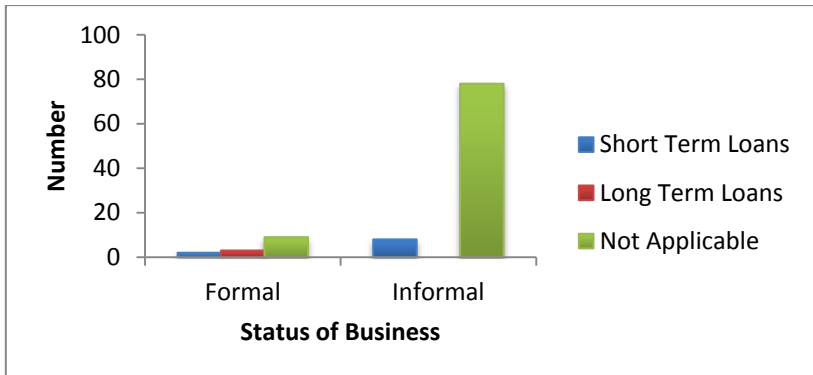


**Table 10.5: Reasons to Avoid Financing from Bank**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Paperwork	11	2	9	14	10
High Interest Rate	18	2	16	14	19
Bankruptcy Risk	12	1	11	7	13
Other Reasons	3	1	2	7	2
Religious Reasons	76	12	64	86	74
Not Applicable	4	1	4	7	5

76 respondents have mentioned that they avoided bank loans because they considered bank interest un-Islamic. 18 respondents cited too high interest rates as a reason to avoid bank loans. The risk of getting bankrupt as a reason to avoid bank loans was considered by 12 respondents. Three respondents mentioned other reasons to avoid bank loans. Four respondents have no issues in borrowing from banks. While giving reasons to avoid bank loans the formal sector is bothered by paperwork more than the informal sector (14 percent as compared to 10 percent of the informal sector.) High interest rate is a reason to avoid bank loan for 19 percent of the informal businesses, while fewer of the formal businesses mentioned this as a reason (14 percent.) Bankruptcy risk bothers the informal businesses more than the formal ones (13 percent for informal; 15 percent for formal.) More formal businesses consider religious reasons, as compared to the informal businesses, as a factor for avoiding bank loans (86 percent the formal businesses as compared to 74 percent the informal.)

**Figure 10.6: Type of Loan**



**Table 10.6: Type of Loan**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Short Term Loans	10	2	8	14	9
Long Term Loans	3	3	0	21	0
Not Applicable	87	9	78	64	91

Responses for the type of bank loan indicate that ten respondents have taken short term loans, three respondents have, long term. 87 respondents denied taking any bank loan. The Formal businesses benefited more by loans as 35 percent either have a long term or a short term loan as compared to the informal businesses where only 9 percent have any loan. Formal businesses are also more comfortable with long term liability as most of the formal businesses have taken long term loans (21 percent as compared to 14 percent short term) whereas most of the informal businesses prefer short term liability (Nine percent as compared to zero percent long term.)



Figure 10.7: Collateral against Bank Loans

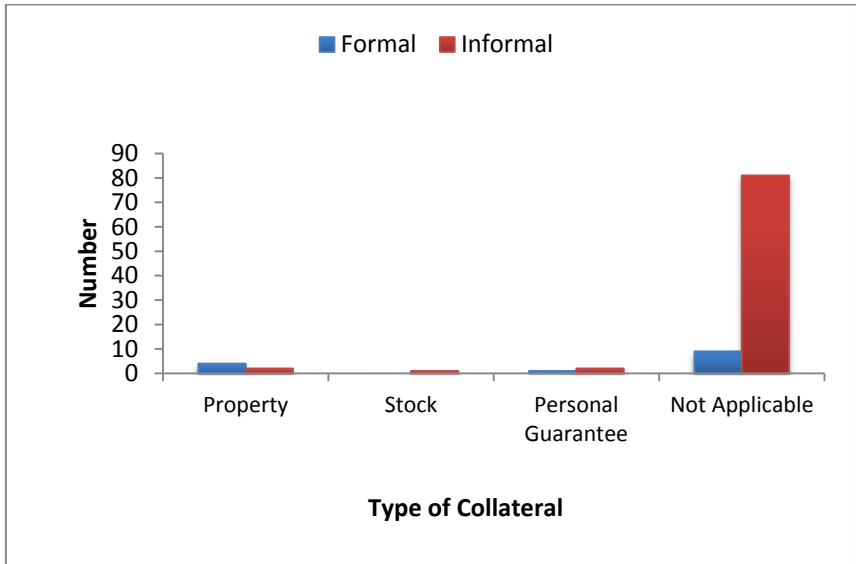


Table 10.7: Collateral against Bank Loans

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Property	6	4	2	29	2
Stock	1	0	1	0	1
Personal Guarantee	3	1	2	7	2
Not Applicable	90	9	81	64	94

Only ten percent of respondents have borrowed money from the bank and personal guarantee is used by 3 respondents as collateral, a property by six respondents and stock by one.

Formal businesses tend to leverage their properties as collateral to raise capital more than the informal businesses as 29 percent of the formal businesses have taken loan against their property (Only two percent of the informal businesses have done the same.) The Formal businesses also use their goodwill to raise capital more often than the informal firms. Seven percent of the formal businesses have taken loans by using personal guaranties, compared to two percent of the informal sector.

### **Conclusion:**

Overall most of the small businesses do not have a bank account. Those who have a bank account often do not have it in the name of the business. Formal businesses are more likely to have a bank account than the informal businesses. Formal businesses also have a tendency to open the bank accounts in the name of the business. The preferred financiers of the formal and informal businesses are friends and family followed by commercial banks. No one likes moneylender in formal sector, while a negligible minority of informal businesses still considers him lender of the first choice. Stated otherwise, moneylender was considered the lender of the last resort by 64 percent formal businesses, a similar proportion of informal businesses (one half) also considered money lender as the lender of the last resort. More than two fifth of the formal and almost one fourth of the informal businesses also considers commercial banks as lender of the lost resort, which says a lot about the popularity of the commercial banks among the respondents. While about one sixth of the informal businesses thought, when all the doors were closed at least friends and family could be requested for helping them out.

Most of the businesses want loans from the bank to finance their growth, second reason is to gain leverage and very few consider the tax benefits of a bank loan. This preference order is same for formal and informal businesses. But one third of formal and two fifth of the informal businesses do not like to take loans from the bank. Most of the businesses, both in formal and informal sector feel reluctant with taking loan from the bank due to religious reason. Due to their experience with paperwork, more formal businesses consider paperwork as a reason to avoid bank loans, yet for their continuous struggle to survive more informal business consider risk of getting bankrupt as a reason to avoid bank loans.

Most of the businesses have not taken loans. Both formal businesses as well as informal businesses have taken short term loans, but long term loans were only taken by the formal businesses. The main reason may be that most of the informal businesses do not have their own properties to pledge with a bank. However personal guarantee was also used by one in every fourteen formal and one in every fifty informal businesses.

### **Case Study: Arthi: The middleman, a Good Samaritan or a Shylock?**

One and a half decade long witch hunt, waged against *Arthi* by government of Punjab and later joined by the State Bank of Pakistan and government of Sindh has failed to weaken this institution, let alone eliminate it. Regardless of the government's version of reality, according to which *Arthi* is a gross exploiter of agricultural and rural economy, who earns hefty profits without adding anything into the value chain of agricultural production, he has a role to play.

During the whole growing season, he provides cash, pesticides, fertilizers or seeds to his *Asami* (borrower) on credit. Usually this

credit is interest free. He does not require his *Asami* to produce *Fard-e Malkiat* (Rent Roll) as collateral like commercial and agricultural banks do. He does not pledge their properties too. He looks at the standing crop, investigates credit worthiness of his *Asami*, and just issues the loan in cash or kind. To him real assets of the borrower are immaterial, but production capacity does matter. He is easy to approach, and does not limit his access with office hours. Is he a Good Samaritan? Probably he is.

But in a world run by “No Free Lunch Principle,” do Good Samaritans actually exist? Certainly, they do not. So, all of a sudden our Good Samaritan becomes a Shylock when he seeks his pound of flesh from *Asami*. The favours of *Arthi* come with the implicit promise that *Asami* will sell the whole production through the commission agency of the financing *Arthi* only. At this point *Arthi* sells the produce in auction market and first collects all of his dues from the proceeds, and then he charges his sales commission which is usually five to 10 percent of the gross sales amount. Sometimes he purchases the produce at market rate himself.

*Arthis* from big cities like Lahore, Islamabad, and Peshawar oblige the rural *Asamis* with their favours and because local *Asamis* sell their fruits and vegetables in the auction markets of these big cities, one can find guavas grown in Sharaqpur cheaper in Lahore than in the retail market of Sharaqpur. A participant of the focus group discussion told that local traders of vegetables purchase the same vegetables from the auction market of Lahore, at a higher price. Which they can source from the local growers at a much lower cast, were the local grower willing to sell them.

By filling the void created by red tape-ism of formal banking sector *Arthi* disturbs the demand and supply equilibrium of food severely, and the production regions suffer scarcity whereas consumption regions receive unearned artificial under-pricing.

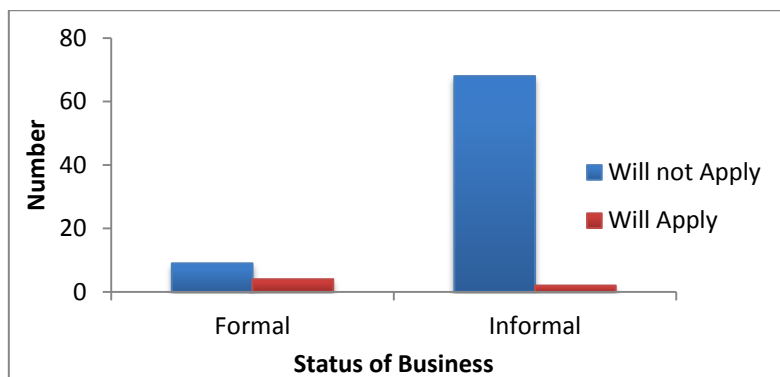
This inherent system of exploitation does not let agricultural communities improve their life style, despite increased per acre production due to modern agricultural practices and technologies those are quickly adapted by local farmers.

Unlike chartered financial institutions those have to follow central bank's policies and guidelines. *Arthi's* financial practices are prone to shenanigans and under invoicing of the auction proceeds, kiting of cheques, and cooking of books often get unnoticed or ignored by the *Asamis* those are in many cases illiterate or semiliterate.

## 11. Special Privileges:

After all they say, “What’s the point in following the rainbow if there is no jackpot at the end?” This section compares the formal and informal sector on the bases of a few special privileges those businesses can receive from the government and other big institutions.

**Figure 11.1: Views regarding Prime Minister Youth Loan Programme (PMYLP)**



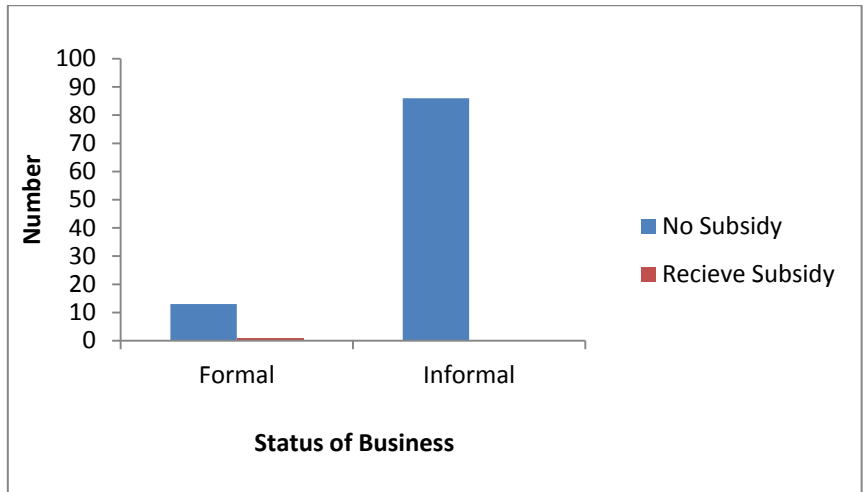
**Table 11.1: Views regarding Prime Minister Youth Loan Programme (PMYLP)**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Do not Intend to Apply	77	9	68	64	79
Intend to Apply	6	4	2	29	2

A total of 83 respondents gave their opinion regarding Prime Minister Youth Loan Program. Though the respondents usually consider the program a good initiative by the government, 77 have no intentions to apply due to cumbersome process, six have plans to apply.

Formal sector was dominant in the endeavours to benefit from Prime Minister Youth Loan Program, 29 percent of the formal businesses have plans to apply or have applied for this program, on contrary only 2 percent of the informal enterprises planned to apply for this program.

**Figure 11.2: Subsidies**



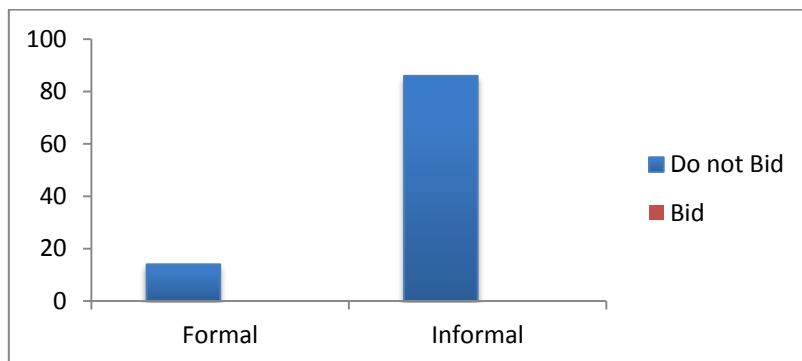
**Table 11.2: Subsidies**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Not Receiving Subsidy	99	13	86	93	100
Receiving Subsidy	1	1	0	7	0

Once subsidies were rampant in every field, now they are very rare. 99 out of 100 respondents do not receive any direct subsidy from the government.

The one business who received subsidy belongs to the formal sector. In percentage terms seven percent of the formal businesses in our sample receive a subsidy, while no informal businesses receives the same.

**Figure 11.3: Bid against Tenders of Public Procurement**

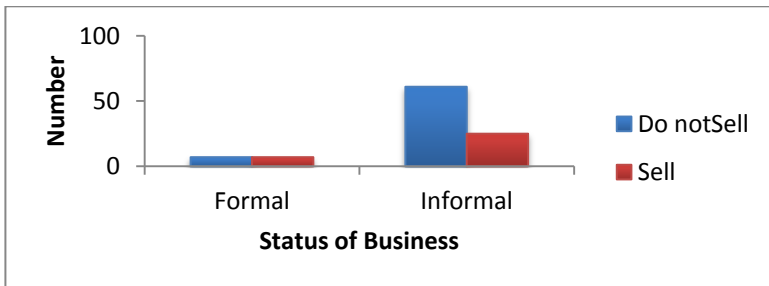




**Table 11.3: Bid against Tenders of Public Procurement**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Don't Bid	100	14	86	100	100
Bid	0	0	0	0	0

None of the respondents bid against the tenders of public procurement.

**Figure 11.4: Dealing with Institutional Buyers****Table 11.4: Dealing with Institutional Buyers**

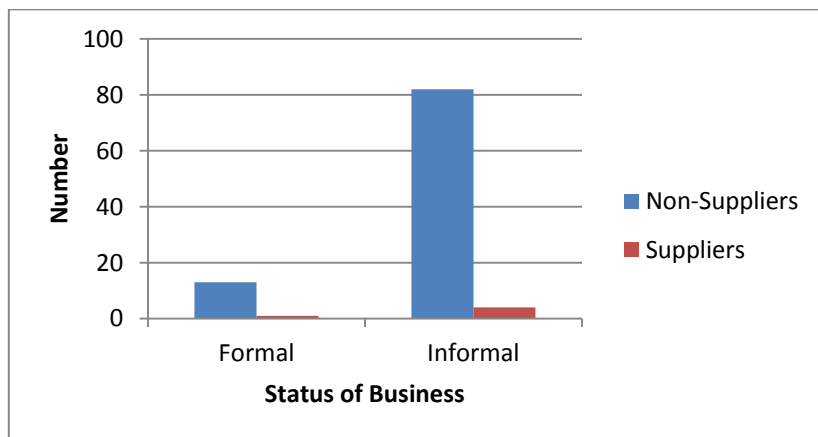
				D.I.B as a %age of the Sector	
	Overall	Formal	Informal	Formal	Informal
Don't Sell	68	7	61	50	71
Sell	32	7	25	50	29

Thirty two businesses sell their products or services to institutional buyers, 68 do not. Half of the formal businesses sell

to institutional buyers, where only less than one third (29 percent) of the informal businesses manage to cater to the needs of institutions.

The mere fact that informal businesses sell to the institutions proves that having a status of unregistered business does not harm a business’s ability to deal with the institutional buyer.

**Figure 11.5: Supplier to Local Institutions**



**Table 11.5: Supplier to Local Institutions**

	Survey Results (In Numbers)			Survey Results (In Percentage)	
	Overall	Formal	Informal	Formal	Informal
Non-Suppliers	95	13	82	93	95
Suppliers	5	1	4	7	5

Only five businesses are short listed suppliers to local institutions. Formal businesses are slightly better off (7 percent as compared to 5 percent of the informal businesses.)

**Conclusion:**

Formal businesses have a greater chance to apply for government led pro-business initiatives, slightly less than one third businesses in formal sector applied or planned to apply for recently issued soft loan scheme Prime Minister Youth Loan Scheme as compared to the negligible 2 percent of the informal. Subsidy culture is taking its last breath in Pakistan, still formal businesses are more likely to receive subsidy. One of the greatest advantages of being a registered business is being eligible to bid on public sector procurement tenders. But formal businesses in Sharaqpur did not benefit from this opportunity. One interesting thing is that despite the purchasing manuals and procurement policies of a number of public sector and private institutions discouraging the official buyers from sourcing goods and services from informal businesses; informal businesses not only manage to sell these organizations, but they also get a status of short-listed suppliers at times.

## 12. Concluding Remarks and Recommendations:

The study of small enterprises in Sharaqpur made it clear that overall formal businesses were in a better position when we compared the two kinds of enterprises on a number of grounds. But the vital question still remains unanswered. Why informal businesses do not get them registered and reap the same fruits which formal businesses are enjoying due to their formal status? The answer is that status quo led laws and officials and cumbersome procedures are hindering them from joining the club. Due to cultural reasons, the results of our study might be slightly different from Hernando De Soto's study in Lima, or P.D Kaushik's study in Delhi, but still they support the legalist models.

The story repeats itself in every third world country. First the state formalizes businesses, creates regulations, issues licenses and imposes taxes on businesses; this creates significant entry barriers for new and small businesses. These established businesses progress by leaps and bounds. Others become convinced about the importance of getting formalized, receiving the same privileged status, and contact the officials to get the registrations, land titles and licenses. A few opportunist officials who know the importance of getting formalized, as well as the applicant does—start asking for bribes to the new entrants, and new entrants pay them. Meanwhile the entry barriers help the established businesses in creating rents. The new entrants calculate that the game is not worth the candle, so instead of applying for licenses, permissions, or regulation they just open a shop or stall and start doing business. When they are confronted by the state, they usually end up at a compromise.

Meanwhile lawmakers realize that tax revenue is not increasing by the speed of the economy. So they create tough laws to curb

the unregistered businesses and increase the tax rates at the existing formal enterprises. This makes it profitable to remain informal and invisible to the eye of the state. When lawmakers see that existing laws are not controlling informal economy, they create tougher laws. These tougher laws empower law enforcers to harass the informal business to a greater extent. At this step the informal business again vows to get a registration. But now corrupt officials do not get him registered and send him from pillar to post till he gets dejected and comes back to his shop and for next many years he tries to avoid government offices like a plague and tells at least ten other friends what happened to him when he tried to get registered.

But the men and women in the ministry of finance are not fools either, they need tax revenue and more tax so they bring an innovation, they start deducting indirect taxes in the name of advance tax and withholding tax, which they promise to return at the end of the financial year, if it was more than the actual tax levied, but only registered business can demand this refund. Now the tax hounds complete their tax target, by extracting tax from people those in many cases do not earn enough to qualify for the lowest income-tax bracket. The cost of doing business increases for the informal businesses and they start shifting the burden of these advance and withholding taxes to the end consumer.

Excluding a large portion of the national economy by making new laws does not control the phenomenon of informality. Formalizing the informal businesses is the real solution for all the stakeholders instead of marginalizing it. In this way, more opportunities will be opened for currently informal businesses at the same time the state will have more registered tax payers and more exact data to form fiscal and economic policies. The initiative taken by Hernando De Soto, his Institution of Liberty

and Democracy (ILD) and Peruvian Government in Lima can be taken as an example of what formalization of informal businesses and giving them property rights can do to an economy. Learning from the work of De Soto in Peru and Kaushik in Delhi we believe following reforms need to be done to formalize the informal economy of Pakistan.

### **One Window Operations:**

To comply with a number of registration and reporting requirements, the businessman has to go to a number of government offices which costs him a lot of time. According to an estimate a Pakistani entrepreneur has to spend 560 hours in a year, similarly he has to make about 47 tax payments in a year.<sup>36</sup> This wastage of time makes entrepreneurs shy away from registration. Instead of sending every entrepreneur to every office, the state can appoint liaison officers in every locality those will collect all the paperwork from the entrepreneurs and get it processed by the concerned departments and deliver it back to the entrepreneur at his business premises. In our opinion the Post office network, with its offices all over the country and staff conversant with paperwork, is capable to provide such a service within its present resources.

### **Installing Process Circuit Breakers:**

It takes a lot of time to complete one simple procedure in a government office. This slowness discourages an entrepreneur to get registered. For instance it takes 50 days to register a property in Pakistan. And it takes 976 days to recover debt through a court in Pakistan.<sup>37</sup> We suggest a certain time based circuit breaker

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<sup>36</sup> World Bank. Washington, DC, "Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises." World Bank Group. 2013. p.215

<sup>37</sup> *ibid.*

should be installed with the official procedures. For example, if a court does not give its decision within a certain time period, the matter should automatically reach into a higher court. And if an office fails to reply to an application within certain days, the application should be considered as accepted. Such kinds of experiments have been done in Lima during the Institution of Liberty and Democracy (ILD) led formalization of the informal business reform.

**Inclusion of Public in law making:**

Another way to increase the number of formal business is to take in confidence the people, who are subjects to a particular law, during its drafting. The cost and benefit analysis of implementing a new law must be done, and the draft of the new law should be publically displayed for the inputs of the targeted businesses.

**Periodic Revision of existing laws:**

With the passage of time existing laws become obsolete or irrelevant, but they still add to the nuisance value of officials. For this reason laws should be reviewed after a set period of time, say every ten years, and irrelevant laws should be repealed.

**Simplification of laws:**

A plethora of laws collected over the years makes it difficult to follow each of these, when even some of them negate each other. Laws need to be simplified so that they are dis-ambiguous and easy to follow. In Lima when laws were simplified and their number was reduced, a number of businesses suddenly started getting formalized. Similarly different forms and documentations need to be simplified to increase the compliance rate.

### **Merging the Multiple Tax Authorities:**

Federal, Provincial and Local authorities collect different taxes in Pakistan. Complying with a number of the taxmen becomes complex for the entrepreneurs, and he chooses to stay invisible before the eyes of the taxmen for his peace of mind. Having separate departments to serve the same purpose also denies economy of the scale for the government in tax collection. Single tax collection authority can increase the rate of compliance within the business community.

### **Decreasing the Tax Rates:**

High tax rates increase the profitability of those who remain out of tax net. When the taxes will be low, more businesses will have an incentive to be formalised.

### **Spreading the Banking and Insurance net:**

Banks happily accept the savings from the small entrepreneur, but generally, do not lend him the money to run his business. A lot of new prospects could be opened if they start considering the small business sector as a preferred borrower. Few years ago, initiative of Pakistani bankers to tap consumer sector finance opportunities was quite profitable for the major banks. Similarly small business sector offers them lucrative opportunities. The inherent credit risk associated with financing the small businesses can be minimized by the synchronized spread of insurance net along with financing from the bank. At present the awareness about the need of buying insurance is not at its ideal level, the insurance companies need to do a lot of marketing efforts.



### **Moral Training of the Officials those deal with Public:**

One reason of avoiding to get registered with the government departments is lack of trust between officials and business men. Sometimes, officials call bad names to the businessmen, sometimes even physically assault them, and occasionally take the products from them without paying. This attitude creates a distance between the entrepreneur and the state. Therefore, when the officials interact with the businesses, they need to realize the importance of being polite. They should be given training on proper moral behaviour. Psychometric tests should be taken by the candidates for these posts, and bad tempered people should not be allowed to take charge as an inspector.

### **Bringing the Institutional Paradigm Shift:**

From time to time, a whole public sector department becomes an Augean stable of corruption. At that point the whole department can be changed. For example in recent past, when the traffic police in Lahore earned a bad reputation for asking for the bribes and being a nuisance to the motorists, the whole department was changed with a new Traffic Warden System. This brought a relief for the people on the road. However this approach is not practical always.

### **Proactive and Sympathetic Law Enforcement:**

A culture of letting the illegal development happen and then when they reach at their peak, taking action and becoming a hero in front of their higher-ups for catching “a big fish” prevails among the inspectors of different government department. In our opinion such inspectors should be punished instead of being applauded for letting it happen the first instance.

Moreover, if a minor crime does not violate the rights of other people and the state, the benefit of doubt should be given to the

accused. For example let us suppose a multi-storey building was approved till the seventh floor, and the builder constructed the eighth floor in good faith that the foundation was strong, it was not violating any building code and he would get the permit meanwhile. He had done it illegally.

But instead of bringing heavy machinery and demolishing the eighth floor and cracking the legally constructed structure of the seven floors with the vibration of the demolishing machinery. Just to make it an example for others. A better approach would be to call an impartial and competent building consultant, get him to inspect the eighth floor. And if the eighth floor does not violate any existing building code, a permit should be issued and the fee of the consultant along with fine should be received from the builder.

#### **Strengthening the Regulators:**

The regulators should not be selected on political grounds. And to make sure that they are impartial, they should have secure job tenures, attractive salaries, and control over the finances of their department/jurisdiction. Such impartial regulators will ensure that no one is being harassed for bribes etc.

#### **Simplifying Official Languages:**

The English of Raj era, is used in many official documents, which is not legible for even a university graduate, and surely not for the semi-literate shopkeeper. Similarly land title deeds are written in such a rich mixture of Farsi and Urdu languages that even the owner of a property cannot know what he actually owns by reading a title deed. We are not denying the importance of a set vocabulary, but when language becomes a tool of alienating, instead of communicating, it needs to be simplified.

**Spreading the Financial literacy:**

Banking sector, most of the formal businesses and taxmen use double entry system of accounting, while most of the informal entrepreneurs are oblivious of this. Many an illiterate businessmen have to hire a dedicated accountant just to fulfil the reporting requirements of the tax authorities; this increases the operating cost of the business. If financial institutions can divert some of their Corporate Social Responsibility (CSR) budget at teaching the informal entrepreneurs the double entry system of book-keeping, they will eventually be able to benefit from a lot of potential debtors. The same model is being implied by agriculture input firms, those teach farmers the modern methods of farming and farmer purchase their products in their fields. And both farmer and the input firm benefit from this transfer of knowledge. The spread of financial literacy can also bridge the gap between the state and informal businesses.

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# **Small Enterprise: Choice between Formality and Informality Survey Questionnaire**

## **1. Legal Status**

**1.1. What is the legal status of your business?**

- a) Sole proprietorship
- b) Partnership
- c) Private Limited
- d) Cooperative
- e.) Family based  
collective ownership.

**1.2. Have you ever changed legal status of your enterprise?**

- a) No
- b) Yes (please specify the exact shift) \_\_\_\_\_

**1.3. Do you have a written partnership deed in case your  
business operates as a partnership?**

- a) Yes
- b) No

**1.4. Do you consider your business as a separate entity  
from yourself?**

- a) Yes
- b) No

**1.5. Can your business be used as a guarantee in a court of Law?**

- a) Yes b) No
- c) Do not know

**1.6. Are you sales tax registered?**

- a) Yes b) No

**1.7. Are you income tax registered?**

- a) Yes b) No

**1.8. Are you a tax withholding agent?**

- a) Yes b) No

**1.9. Do you receive any subsidy in business?**

- a) Yes b) No

**1.10. Do you file tax returns?**

- a) Yes b) No

**1.11. Do you receive any tax rebates?**

- a) Yes b) No



## 2. Business Process

### 2.1. What modes of payment you utilize or accept?

- a) Cash/Currency
- b) Cross Check
- c) Bearers Check
- d) Online transfer
- e) *Hawala*

### 2.2. Which of the following document you use?

- a) Cash Register
- b) Debit and Credit Vouchers
- c) Stock Register

### 2.3. What entry system do you use?

- a) Single entry system of book keeping
- b) Double entry system

### 2.4. Do you close your books at least once a year to access the performance of your business?

- a) Yes
- b) No

**2.5. Have you been licensed by or registered with following departments? (Please select all that apply)**

- |                                       |                                     |
|---------------------------------------|-------------------------------------|
| a) Food Department                    | d) Tehsil Municipal Administration. |
| b) Environment Protection Authority   | e) Department of Health.            |
| c) Employee Social Welfare department | f) Other Authority                  |

**2.6. In case of any complaint with the government, how do you usually register your protest? (Please specify one)**

- |  |                                     |
|--|-------------------------------------|
| a) Register formal complaint               | c) Strike                           |
| b) Talk to the concerned official directly | d) Seeking help of your association |
|  | e) No response                      |

**2.7. Which of the following contract enforcement agency you find most effective?**

- |           |                     |
|-----------|---------------------|
| a) Courts | c) <i>Panchayat</i> |
| b) Police | d) Arbitrator       |

**2.8. Has a political party or person helped you at a time against a government servant?**

- |        |       |
|--------|-------|
| a) Yes | b) No |
|--------|-------|

**2.9. Has an inspector from a government department paid a visit to your business premise for last one year?**

**Please tell us about your interaction.**

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**2.10. Are authorities like TMA and Police compassionate and helpful with entrepreneurs like you?**

a) Yes

b) No

**2.11. Are you happy with your present status of business or you want to expand it?**

a) Yes(Expand)

b) No(Content)

### **3. Access to Finance**

**3.1. Do you have a bank account, what does its title say?**

a) The name of your  
business

c) No Bank account.

b) Your Name

**3.2. Who is your lender of the first choice?(Please select one)**

- a) Commercial bank
- b) Moneylender
- c) Friends and family

**3.3. Who is your lender of last resort? (Please select one)**

- a) Commercial bank
- b) Moneylender
- c) Friends and family

**3.4. If you prefer financing from a bank, it is because?**

- a) It gives your business leverage
- b) it gives you some tax benefits
- c) You need the help of the bank to
- d) finance your growth.
- e) Other reasons
- f) Not applicable

**3.5. What type of bank loan have you taken?**

- a) Short Term
- b) Long Term
- c) Not applicable

**3.6. In case you avoid taking loans from the bank, what are the reasons?**

- a) You feel uncomfortable with paper work
- b) Interest rates are too high
- c) Risk of getting bankrupt bothers you
- d) Other reasons
- e) you consider bank interest un-Islamic
- f) Not applicable

**3.7. If you have taken the bank loan, what is the collateral against it?**

- a) Bank Balance
- b) Property
- c) Inventory/Stock
- d) Personal guarantee

**3.8. To minimize the impact of unforeseen events have you insured your business?**

- a) Yes
- B) No

**3.9. What do you think of Nawaz Sharif Youth Loan Program, will you apply for it?**

## 4. Company Profile

### 4.1. What is the sector in which your business operates?

(Please select only one)

- |                               |                        |
|-------------------------------|------------------------|
| a) Industrial supplies        | transport,             |
| b) Industrial manufacturing   | commission agent, etc) |
| c) Agricultural supplies      | f) Retail              |
| d) Agricultural manufacturing | g) wholesale           |
| e) Services (workshops,       | h) Restaurants/Hotels  |
|                               | i) Any other           |

### 4.2. What is the size of your Business in terms of annual revenue (in rupees)?

- a) Up to 1,000,000
- b) More than 1,000,000 but less than 1,500,000
- c) More than 1,500,000 but less than 2,500,000
- d) More than 2,500,000 but less than 3,500,000
- e) More than 3,500,000 but less than 5,000,000
- f) Above 5,000,000

### 4.3. What is the size of your business in terms of number of employees?

- |             |             |
|-------------|-------------|
| a) 1 to 5   | d) 20 to 29 |
| b) 6 to 9   | e) 30 to 50 |
| c) 10 to 19 | f) Above 50 |

**4.4. Which of the following you are member of? (Please select all that apply)**

- a) Trade association
- b) Labour union
- c) Market committee
- d) Chamber of commerce

**4.5. Do you bid against the tenders of public procurement?**

- a) Yes
- b) No

**4.6. Do institutional buyers procure from your business?**

- a) Yes
- b) No

**4.7. Are you a bona fide shortlisted supplier to a few Government Institutions, Multinational Organizations and NGOs?**

- a) Yes
- b) No

**4.8. Do you own your business premises, or it is rented?**

- a) Owned
- b) Rented
- c) Others (Please Specify)

**4.9. Particulars of the Business**

Name of the Business.....

Respondent's name and designation.....

Address and contact number.....

## ABOUT THE AUTHOR



**Asad Ullah** works as a consultant for small scale enterprises in Sharaqpur, where he helps them in documentation, efficiency and modernization of their businesses. He has worked with many small enterprises on their path of growth particularly in education, agriculture and small scale manufacturing sectors. Asad is also a farmer himself and actively looks for ways to unlock the potential in the economy of villages. Asad Ullah holds a BSc (Hons.) in Applied Management from Government College University, Lahore.



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By simplifying regulations, decreasing corruption, debottlenecking procedures, lowering tax rates and making it easier for them to own their business premises, a lot more businesses can be brought into the formal sector, than coercion, penalties, punitive taxes, heavy fines and demolition of buildings with earthmoving machinery can collectively bring because no amount of coercion can outsmart the acumen and ambition of an entrepreneur.  
*(Excerpt from Preface)*

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