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No cakewalk for businesses

A CAKE manufacturer thinking that she did not have enough money for an outlet of her own started her business by putting her cakes in shops and bakeries owned by other people and giving a commission on sales. Her cakes needed proper attention though: refrigeration at the right temperature at all times, careful handling when being moved, and so on. She could ensure all of this up to the time of delivery to the shops but would have had little control over the handling of her product once it was delivered. Pretty soon, she realised that this was a bad model for selling her ware as the shops did not take care of her cakes in the same way as she would have. If a cake went bad and was sold, she took a hit both in terms of revenue and reputation.

Eventually, she opened up her own outlets and has a thriving business now. She started her business about three decades ago. If she had started it today, with motorcycle delivery as cheap as it is now and with telephony costs as low as there are today, she could have a direct delivery model and not have needed many outlets. Thirty years ago, this would not have been feasible.

Businesses require complex contracting. They have a whole range of relationships that they need to forge with upstream suppliers, employees, downstream wholesalers, retailers and buyers. Where complex products are made and/or complex services are being provided, the number of these relationships involving raw material, parts and services, can run into the hundreds (think of an automobile manufacturer's links with suppliers and vendors). The nature of these links can be quite complex. From buying products/services (say, tyres in the case of automobile manufacturers) and from the market to the decision to make certain parts within the organisation (for example, the engine), a typical firm will need an entire spectrum of methods to configure and contract its relationships.

For environments where complex contracting is just not feasible, or is too costly, firms have the option of either going to the market to buy parts off the shelf or to manufacture these themselves. But they do not have access to most of the forms of contracting where long-term contracts, customised product contracts, etc are concerned. This restriction distorts the product and service markets and it impacts the growth path of firms and industries.

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If the cake manufacturer could have had access to reliable, affordable and enforceable contracts with the bakeries and shops in question, she could have ensured good care for her cakes and would not have needed to bring the retail operation into her own organisation. The cost of opening retail outlets is not trivial. Imagine how many cake manufacturers are not in business because they cannot afford to open up retail points. If these contracts had been available, the manufacturer would have focused her energies on making the cakes even better, and expanding to more outlets. The growth trajectory for her business could have been very different. Instead, she focused, for the first many years, on opening a retail point of her own.

I am using the cake manufacturer as an example. But this is true for almost all product or service providers one can think of. A car-parts manufacturer told me that he made his own nuts and bolts as he could not rely on the 'market' to provide him with the quality or quantity he needed, and according to the time schedule he wanted these by. A retailer of clothing set up his own stitching unit because he could not get a single reliable tailor shop from the thousands of tailoring units already working in a city as large as Lahore.

A university finds it hard to manage relations with adjuncts, and instead, works with less-qualified but full-time employed teaching fellows. Another university feels that it cannot rent existing buildings as hostels for students as they are not custom-built, but it cannot go into long-term contracting with investors to construct customised buildings for them, so they are forced to spend capital, which they could have spent on faculty improvement, expanding programmes, building hostels, and so on. A retail chain-store owner mentioned that he had only four branches as that is the number of adult sons he had. He could not rely on professional management to run his stores so he limited his business expansion to four stores.

All this does not mean that no contracting relationships are possible in our society. There are many that are possible and are working. And we live in a dynamic world where things change over time and new possibilities open up. But the issue is that a weak contracting environment and weak contract enforcement raise costs for firms, foreclose some options, distort growth paths and often make firms choose second- or third-best options. It also inhibits certain innovations from coming through.

We do not have a K Mart or Walmart equivalent in Pakistan. Is one reason for this the issue of weak contract enforcement? Bata and Servis have had hundreds of outlets in Pakistan for decades. Banks have had branch networks as well. Why has it been so difficult to see this happening in the area of retail? Even in pharmaceuticals, where reputation effects favour oligopoly arrangements (Fazal Din has a reputation, people would prefer a Fazal Din outlet to a stand-alone outlet) chain-stores have only just started to come in and the franchise model is still in a stage of relative infancy.

Reform conversations in Pakistan are stuck at the macro level and in managing stability. But the real conversations have to get micro. Here is an example of an area that needs significant reform. If the idea is to increase industrialisation, increase exports and generate employment, the real gains might now come from micro-level reforms like the above.

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