

# System faults

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Sometime ago we organized a regional international conference at our institution. We expected more than 250 odd people to attend, with forty plus papers to be presented and guests from fifteen odd countries. As part of the package that we were going to give to all participants we decided to have some pens and bags, bearing the logo of the conference, made. This turned out to be more of a mess than what we had bargained for.

We had called for quotes, and there had been quite a few companies who had responded. Some of them were companies we had worked with before too. After due diligence, we placed the orders. The companies reneged on the contract and kept re-negotiating the terms almost all the way through to the last day. The bag company could not make the bags that they had initially made as samples so we had to change the design a bit to accommodate their limitations. It was too late to change the vendor as such. Then the company said their 'karigars' had run away so they could not deliver the bags a few days before the conference as they had initially promised, but would deliver them the evening before. They could only deliver half the number the evening before, and the other half one day into the conference. And then some of the bags were exceptionally dirty. Clearly the vendor did not put much store on quality. The pen guy created similar problems. We had to change the design of the pens since he could not import the right raw material in time.

One could argue that the problems occurred since these were one time orders and the vendors did not expect the relationship to endure, and so they did not have to worry about what repercussions their actions would have on their future, and could concentrate on the more stable customers while filling in our order during the slack periods. But this does not gel with the conversations I have had with more regular buyers either.

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he could spend on expanding and managing the retail business. Furthermore, if he has set up a tailoring business that caters to his peak demand, he has probably created some excess capacity in the industry as well. Again all of the above factors work towards reducing the efficiency of both the tailoring industry and the retail business in Pakistan. If there are many people like this retail store owner, we have a significant efficiency gap here.

Virtually the same story was narrated to me by manufacturers and retailers from at least two other areas. A large mithai manufacturer mentioned that he was producing his own 'desi ghee' since he could not get any ghee manufacturer to deliver the quality that he desired, and on the schedule that he could live with. An automobile parts manufacturer said that he had design and manufacture every component of the parts that he made since he did not have specialized vendors in the auto market, and up stream from him.

From the other side, we talked to a number of manufacturers who were not going into retailing since they could not find appropriate retailers for their products. A cake and pastry making outfit was forced to open its own outlets across the city as the existing outlets were not satisfactory, and could not handle their products well. This cake maker made very high quality and expensive cakes. She wanted that her products should be treated well, should be presented well, should be kept in a well controlled environment, and should not be served if they got spoiled for any reason. But most retailers did not

ments. The retailer or the manufacturer wants the other party to develop and dedicate some resources for his exclusive use. The large retailer wanted a tailoring outfit that would give his work more priority, as did the mithai manufacturer and the automobile part manufacturer. On the other hand the same demand was made by the manufacturers from the retailers.

But the question is, if one side to a transaction does not trust the other side to carry out its obligations, efficient contracting cannot happen. Here I am using the notion of 'trust' in a rather peculiar way. By trust I not only mean trust in the normal sense of the word where you have a strong belief that the other side will carry out her obligation, but by trust I also mean that there is the backing of a legal framework that can ensure that you carry out your obligations once you have contracted them, and if you do not, then the other side is compensated accordingly for the losses that it might have had to bear due to your non-compliance.

This is where one of the chief problems seems to be. The two sides cannot trust each other as they know they have other clients that they can deal with all the time, the current client is fickle, the legal system is weak and cannot enforce contracts, and even if it does, the cost of ensuring enforcement is too high, and specific investments would therefore have a high likelihood of being wasted. Hence neither side goes into such a contract or honours one.

For more developed economies transactions cost economics literature has shown that similar problems are handled by devising more complex contracts, with more clauses and contingencies, to protect both sides. At the same time specific arbitration channels are kept open to handle any disputes. The legal and administrative framework is sophisticated enough to ensure that it has the competence to enforce compliance from the parties involved in any transaction, and in case of a breach it has enough power that it can ensure due compensation for the aggrieved party. This is missing from Pakistan. The result is that more complex contracting is not resorted to, and instead, we seek simpler solutions that mean either the party has to do without the product, or has to depend on low quality product available in the market.

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One could argue that the problems occurred since these were one time orders and the vendors did not expect the relationship to endure, and so they did not have to worry about what repercussions their actions would have on their future, and could concentrate on the more stable customers while filling in our order during the slack periods. But this does not gel with the conversations I have had with more regular buyers either.

The owner of a very large retail outfit, who also has a brand name clothing line, told me that they could not find good tailoring outfits that could fulfill their regular and substantial orders on a long-term basis. Most people who he had worked with could not deliver the products in time, on the schedule that he wanted, and could not guarantee the quality that he required. As a result, he had to change vendors all the time, use more than one vendor even for the same product, had to run after the vendors constantly, and had to have every piece checked for quality before accepting it. All of the above raised his costs, in terms of time and money, substantially. After chasing up on the suppliers for years, the owner of the retail chain decided to set up his own tailoring unit.

But this is a very inefficient way of expanding business. The retail store owner's expertise lies in retailing, and his brand name is connected to retailing as well. He might or might not have the experience, expertise and acumen to control the tailoring unit, and since the business is different from his core business, he will definitely be reducing the time that

since they could not find appropriate retailers for their products. A cake and pastry making outfit was forced to open its own outlets across the city as the existing outlets were not satisfactory, and could not handle their products well. This cake maker made very high quality and expensive cakes. She wanted that her products should be treated well, should be presented well, should be kept in a well controlled environment, and should not be served if they got spoiled for any reason. But most retailers did not heed her requests. Since every time a customer had a problem with her products she would get the blame, even if the fault was that of the retailer, she decided she had to open her own outlets. The same happened to another tailoring outfit who had to go into retailing themselves.

As the examples given above show, the problems of managing vertical relationships are quite general in our economy. The issue is complex. But what should also be clear is that if these factors are hampering the development of individual firms in any way, and they are, if they are forcing firms into growth that does not respect their core competencies and demands of specialization, which again they are, then the economy is paying a heavy cost because of the current industrial setup.

Though we have just initiated some research to look at these issues in more detail, but we do have some preliminary hypotheses that might provide some explanation. The issues identified are surely concerned with the issue of asset specific invest-

ment, which is not being addressed by the existing legal framework. The legal framework is not well developed enough to ensure that it has the competence to enforce compliance from the parties involved in any transaction, and in case of a breach it has enough power that it can ensure due compensation for the aggrieved party. This is missing from Pakistan. The result is that more complex contracting is not resorted to, and instead, we seek simpler solutions that mean either the party has to do without the product, or has to depend on low quality product available in the market, or has to take up the function itself. So the retailer sets up his own tailoring unit and the mithai producer sets up his own ghee manufacturing.

We are not going to talk about judicial reform here to address this problem. That is too big a subject to tackle here. But we can point out that tackling judicial reform is probably the most efficient way of dealing with this issue. Short of that though, one can think of industry and trade specific solutions to this problem. If trade organizations could guarantee the behaviour of their members, that too will address the problem. But this is only the second best solution.

Legal and system lacunas are hampering the ability of businesses to grow in an efficient and optimal manner. We have shown a few ways in which this is happening in just a few instances. The impact is much deeper and larger. We need to address this issue through institutional reform, especially judicial reform.

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