



# [SMEs and growth in Sub-Saharan Africa]

Identifying SME roles and  
obstacles to SME growth

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By

**Sveinung Fjose**

**Leo A. Grünfeld**

**Chris Green (SQW)**

**MENON Business Economics**

Essendrops gate 3, 0303 Oslo, Tlf: 97 17 04 66, <http://www.menon.no>



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# 1 Why SMEs and growth in Sub-Saharan Africa?

This report highlights the role that small and medium sized enterprises (SMEs) play for growth and development in Sub-Saharan Africa. Essentially, the report contains a discussion of three closely related subjects.

***A shift towards high and persistent growth in Sub-Saharan Africa***

First, it provides a mapping of growth patterns in Sub-Saharan Africa over the last 20 years. During the last decade we have observed a strong shift towards high and persistent growth in many of the countries in the region. We argue that the most important drivers behind this shift are increased public and private investments, fuelled by an improved business environment, which also propels SME activity. In addition we have experienced a long lasting rise in several commodity prices. Furthermore, India and China have gradually become important investors and trading partners for these countries, adding to already increased export demand from OECD countries. Strong economic growth gives rise to a jump in foreign investment driven by high returns on capital. In fact, Sub-Saharan Africa is the region in the world where US investments have been most profitable during the last 10 years.

***Moving to higher growth, SMEs get to play a pivotal role, supporting service demand and needs for specialization***

Second, we take a closer look at the role of SMEs when developing countries move into a pattern of substantially stronger growth. We show that gradually, these firms play a pivotal role in industrial development and restructuring, satisfying rising local demand for services, allowing for increased specialisation and supporting larger firms with inputs and services. This way, SMEs become engines that sustain growth for long term development. Many countries in Sub-Saharan Africa have a large number of SMEs relative to the size of the economy, but these are almost exclusively micro companies and they are often not part of the formal economy. In this report, we are particularly focusing our attention on SME that are larger than micro companies, and either part of or heading towards the formal economy.

***Participation in the formal economy is a prerequisite for long term SME growth***

Third, we identify the most important obstacles to SME growth in Sub-Saharan Africa. In the region, SMEs are severely hampered by a weakly developed business environment. Red tape, corruption, complex entry regulations etc. provide few incentives to become (or remain) active in the formal part of the economy. Consequently, in many of these countries, a large share of SMEs is not participating in the formal economy. Without being a formal enterprise, access to finance, new markets opportunities and public sector services is severely hampered. We point to a substantial literature showing that there is a strong correlation between business environment and growth opportunities for SMEs. The better the business environment, the more SMEs will be established.

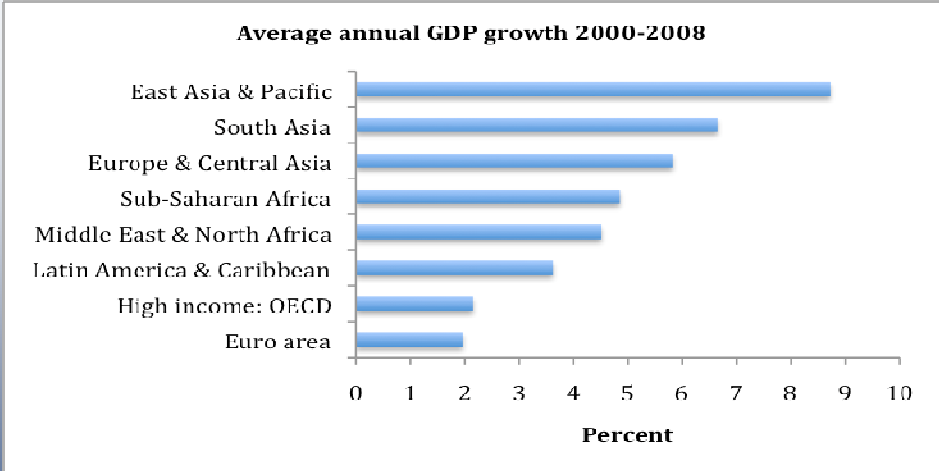
***In terms of policy, enterprises larger than micro firms are largely ignored, forming a "missing middle"***

Growth opportunities in Sub-Saharan Africa are severely hampered by access to finance and stable supply of electricity. Businesses consider access to electricity and finance as the most important challenges when operating and developing business in Africa. Where micro companies meet several assisting financial measures, there seems to exist a lack of instruments supporting the more established, yet still vulnerable SMEs. Among business economists, this lack of focus has been named "the missing middle".

**Lack of finance and unstable electricity supply are the most severe obstacles to SME growth. Measures should address these two problems first**

The obvious long-term solution for improved access to finance and stable electricity is policy improvement on areas such as property rights, regulations on bankruptcy and energy market reform.

**Figure 1: Average annual GDP-growth**



Source: World Bank

## 2 Narrowing down our focus

Since SMEs cover more than 95 percent of all firms in Sub-Saharan Africa, and since the region consists of a large number of countries (see the list below) at widely different development stages and with large differences in industrial structure, it is necessary to narrow the focus of the report. Consequently, we structure the study according to some key elements.

### Focus on SMEs, not micro companies

The term SME covers widely different types of firms. Everything is included, from fragile zero growth micro-firms (normally employing up to a couple of workers generating subsistence level revenues) to fast growing medium sized firms with up to 250 employees. For definitions on size categories, see the box below. The role these firms play for the developing economy and the challenges they face are often completely different. Micro firms often struggle with fluctuating revenues, red tape complexity, and lack of knowledge and relevant competencies. For medium sized firms, access to sufficient amounts of risk capital, access to technology and access to stable electricity supply may be more of a challenge. The report primarily devotes attention to the small and medium size categories, scaling down the focus on the role of micro firms.

### Access to finance and electricity is the key obstacle to SME entry, investment and growth.

As emphasised by Hatega (2007), Kauffmann (2005) and the IFC (2006) report “Making finance work for Africa”, it is relatively clear that weakly functioning financial markets and lack of reliable electricity supply are the far most important obstacles for SME entry, growth investment. Thus we focus on these factors, combined with a discussion of the role of the informal sector.

### SMEs: Definitions and typical numbers

#### SMEs contain:

Micro firms:	1-9	employees
Small firms:	10-50	employees
Medium firms:	50-250	employees

#### Patterns in a representative economy:

Category	Share of all firms	Share of Emp.
Micro	90%	30%
Small	8%	20%
Medium	1.5%	10%
Large	0.5%	40%

### Countries in Sub-Saharan Africa:

A-C:	D-M:	N-Z:
Angola	Dem. Rep. of the Congo	Namibia
Benin	Equatorial Guinea	Niger
Botswana	Eritrea	Nigeria
Burkina Faso	Ethiopia	Rwanda
Burundi	Gabon	Sao Tome and Principe
Cameroon	Gambia	Senegal
Cape Verde	Ghana	Seychelles
Central African Rep.	Guinea	Sierra Leone
Chad	Guinea-Bissau	Somalia
Comoros	Kenya	South Africa
Congo	Lesotho	Swaziland
Côte d'Ivoire	Liberia	Togo
	Madagascar	Uganda
	Malawi	United Rep. of Tanzania
	Mali	Zambia
	Mauritius	Zimbabwe
	Mozambique	

**Narrow focus to some central countries**

We chose to focus on selected countries in the region that represent different economies, country sizes, industrial structure etc. We bring statistical information and cases from these countries only. The selected countries are represented in most graphs and figures in the report.

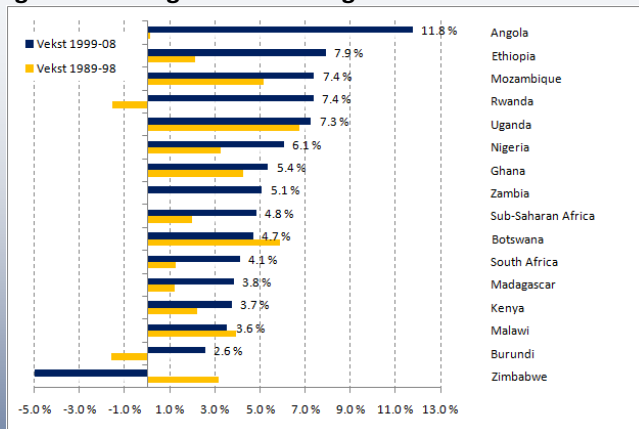
**3 Patterns of economic growth in Sub-Saharan Africa**

Many countries in Sub-Saharan Africa have experiences high growth during the last decade. During this period, growth has been stronger in Sub-Saharan Africa than in the OECD-area. While GDP climbed 10 and 20 percent in the Euro-area and the US respectively, GDP nearly doubled in Sub-Saharan Africa. Apart from a few countries like Kenya and South Africa, countries in Sub-Saharan Africa are not well integrated with international financial markets. As a consequence, the credit crisis was not as severe in terms of growth effects for the countries in Sub-Saharan Africa.

As seen in Figure 2 below, annual GDP growth in Africa averaged close to five percent during the period 2000-2008. This is clearly less than regions in Asia, but substantially higher than Latin America, OECD and Euro-area. Almost all countries in Sub-Saharan Africa have experienced a persistent jump in growth rates (especially in terms of GDP growth per capita). However, growth still differs widely among countries in the region. While Angola, Ethiopia and Mozambique display strong growth, the economies of Burundi, Malawi and not to mention Zimbabwe struggle severely. These rather few countries have not benefitted from the overall jump in growth experienced after 2000.

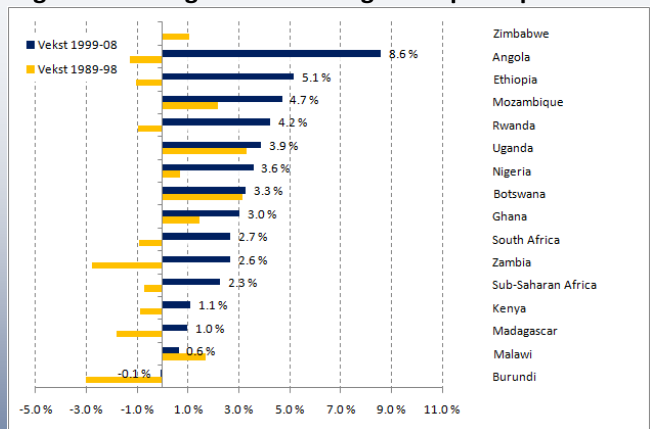
In Figure 12 on page 10, we describe the annual growth rate in the components forming GDP. Clearly, private investment has picked up significantly since the early nineties, giving fuel to long term economic growth. Yet, growth is also

**Figure 2: Average annual GDP-growth**



Source: World Bank

**Figure 3: Average annual GDP-growth per capita**



Source: World Bank

reflected in both public spending and private consumption. In other words, we have seen a broadly spread and balanced growth pattern during the last decade.

This development has evolved along a path where inflation to a large extent has been tamed in most Sub-Saharan countries. Mostly, annual inflation rates have been brought far below 20% (see Figure 4). Furthermore, previously devastating interest payments on external debt have now reached more acceptable levels (see Figure 5). Consequently, economic growth is no longer consumed by excessive inflation, and many governments are able to follow up needs for public investment as public sector funds improve.

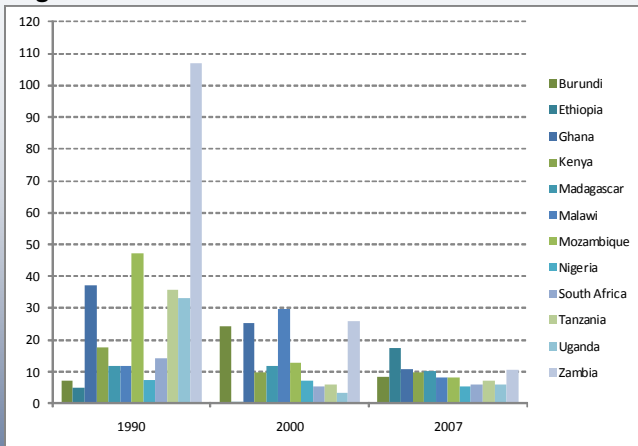
### 3.1 Macroeconomic drivers of Sub-Saharan growth

Differences in growth rates between countries in the region are to a large extent driven by governance and access natural resources. Many countries are producer of raw materials. For instance, the agricultural sector is substantially larger in countries in Sub-Saharan Africa than in other regions of the world, as shown in Figure 6. On average, value added from agriculture was 19 percent in Sub-Saharan Africa in 2008, compared to 2 percent in the Euro-area and 7 percent in Latin America. Moreover, several African countries are highly dependent on exporting selected commodities, such as copper in Zambia, oil in Angola and Nigeria etc. Raw materials as share of export is therefore high in Africa compared to other regions in the world, as shown in Figure 7.

Raw materials and agricultural products account for 70 percent of exports from Sub-Saharan Africa. The share has been relatively stable over time, a pattern that makes Africa different from regions such as Latin America and Asia. Here the share of raw materials in exports has dropped significantly over time, increasing the share of manufactured products.

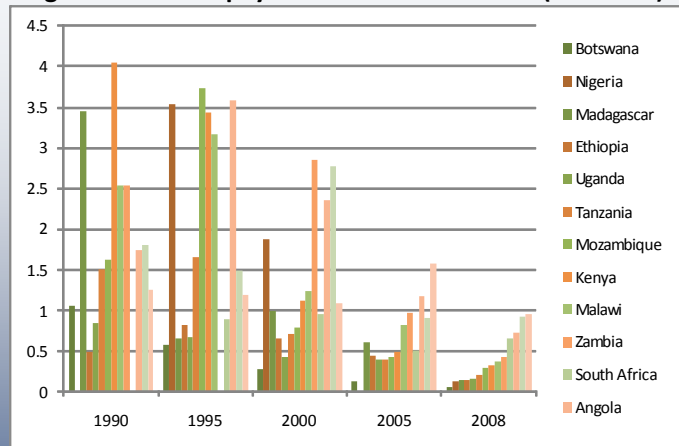
During the last decade prices on what Africa is exporting has increased. As seen in Figure 8, prices on selected commodities have increased substantially during the period. The price of rice, cocoa and copper increased more than 100 percent from 2000-2010, while coffee and maize increased between 40 and 80 percent. During the period 2000-2008, prices actually grew a lot more than shown in the figure.

**Figure 4: Annual inflation rate in selected countries**



Source: World Bank

**Figure 5: Interest payments on external debt (% of GDP)**



Source: World Bank

Lately however, the financial crisis has reduced demand and world market commodity prices. Some of the commodity prices have however started climbing again. A pattern of climbing commodity prices can partly be explained by strong growth in China and India. As shown in Figure 9 below, export to Asia has increased from 3 billion USD in 1990 to 40 billion in 2005. Increased exports to China and Africa have had a significant positive effect on commodity prices. Figure 10 illustrates this point. Between 20 and 25 percent of world imports of crude oil and metallic ores can be explained by increased demand from China and India. Increased south-south trade is now representing a long-term trend. While south-south trade represented 25 percent of developing country trade in 1990, the share climbed to approximately 40 percent in 2009.

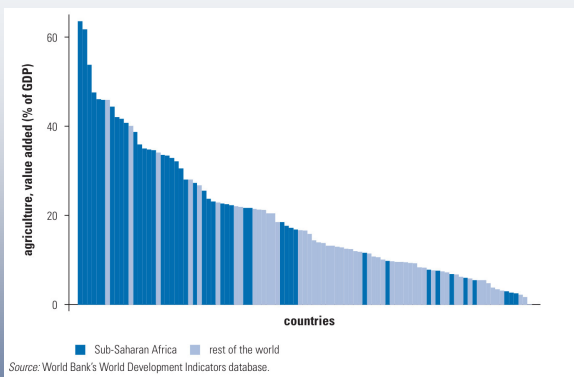
Economic growth in China and India is still strong and is expected to remain strong for many years to come (IMF, 2010). We therefore expect high commodity prices for many years ahead, which in turn will have a positive effect on economic growth in Sub-Saharan Africa.

Growth and solid returns on investments boost domestic investment and inward FDI. A sharp increase in exports from Sub-Saharan Africa has been followed by a jump in FDI going from India and China to Africa. Chinese investors in Africa, like other foreign investors, seek natural resources and regional markets, as well as platforms for exporting to Europe, the United States, and throughout the region.

In Africa, China has been investing in oil production facilities as well as in light manufacturing. India has invested in an array of sectors, including the financial sector as well as food processing and manufacturing (Brodman et al. 2006).

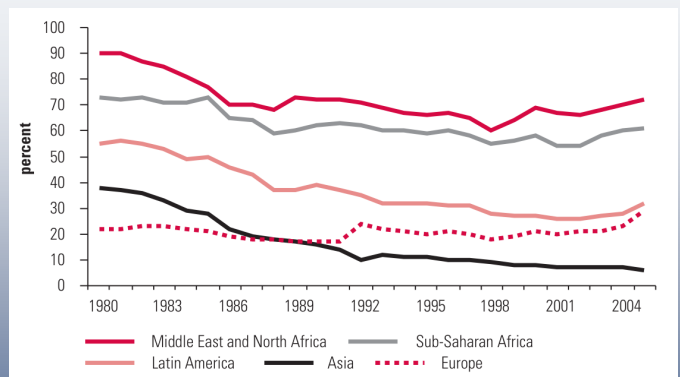
Better prices on what Africa is producing has increased incentives for investments, both domestic investment and foreign direct investments (FDI). As seen in Figure 11, FDI inflows to Africa increased from close to 5 billion USD in 1995 to about 35 billion USD in 2008. According to IMF, more investment, both domestic and foreign is one of the main explanations behind stronger growth in Africa. Figure XX shows that private investment in Sub-Saharan Africa has picked

**Figure 6: Agricultural production as share of GDP**



Source: World Bank

**Figure 7: Share of raw materials in exports**





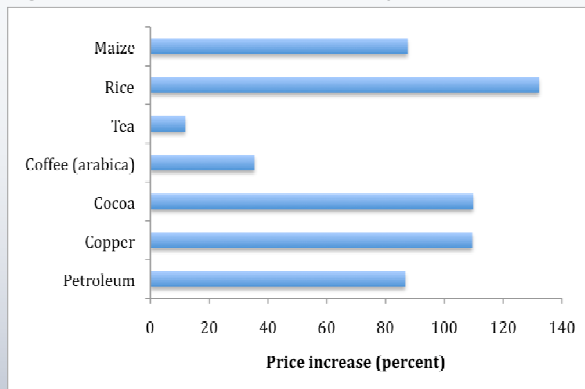
up impressively over the last 20 years, improving the potential for long-term growth.

Strong economic growth in Africa has yielded solid returns on investment. Sub-Saharan Africa is the region in the world where US foreign direct investments have reached the highest return. While investments in Sub-Saharan Africa have provided an average return of 27 percent, investments in Eastern Europe have only given 8 percent. Notice though, that the numbers are quite volatile and uncertain. There are large variations from year to year, and the number of actual investments in Africa compared to other regions is quite small.

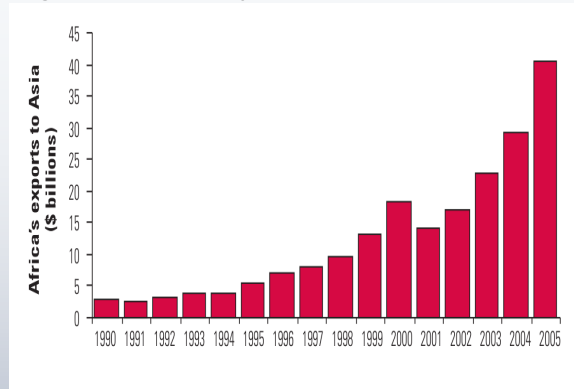
Sub-Saharan Africa’s share of world FDI is only 1.8 percent. Furthermore, annual return on investments in Sub-Saharan Africa seems to have fallen from record high values early in the decade to more normal returns later. Nevertheless, Moyo (2009) has shown that in three of the past five years, African Stock exchanges were ranked among the best places to invest, with listed stock returns averaging 40 percent. Risk premiums on investments have also decreased. On average Sub-Saharan Africa is seen as a less risky region to invest in the last decade. Forty-eight out of ninety African countries held democratic elections that were deemed free and fair, making political risk in several countries considerably lower than a decade ago. Lower risk and high growth makes Sub-Saharan Africa an attractive region for investments.

That fact that Sub-Saharan Africa displays high returns on investment is expected from a risk perspective. Political and institutional risk is higher in Sub-Saharan Africa than in other regions in the world. Political and military coups, ethnic tension and civil wars have been more common in Sub-Saharan Africa than in

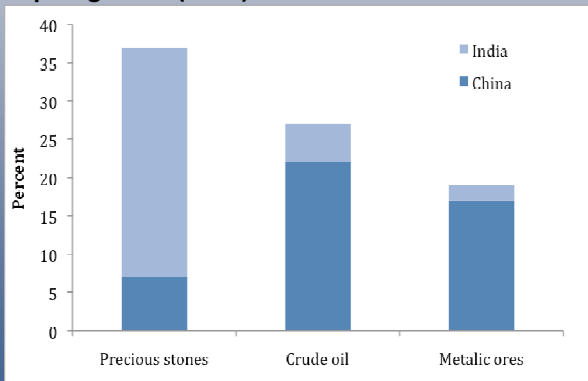
**Figure 8: Growth in raw material prices (2000-10)**



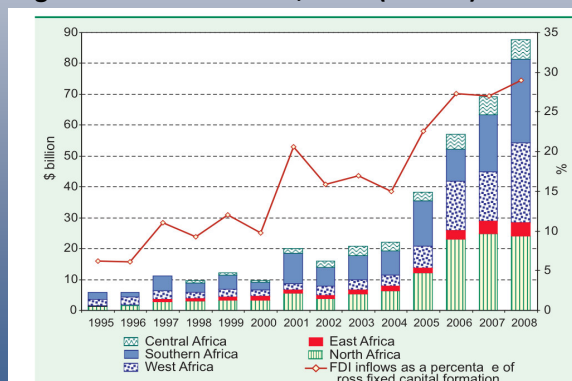
**Figure 9: African export to Asia**



**Figure 10: China and India’s share in world import growth (2008)**



**Figure 11: FDI into Africa, stock (bn USD)**

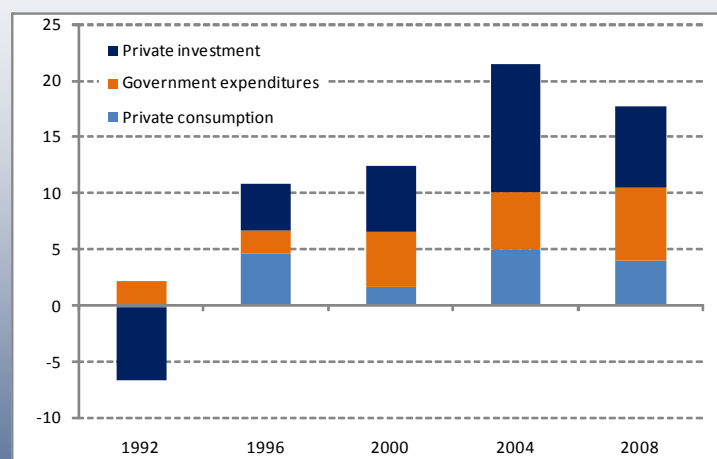


other regions of the world. Since such incidences may lead to a full loss of investments, investors often demand a high risk premium to invest: Emerging Market Private Equity Association have asked businesses in US what risk premiums they demand when investing in other regions than US. Risk premiums on investments have increased in Emerging Asia and Central and Eastern Europe, while decreasing in Middle East, Latin America and Africa. Risk premiums on investments across regions are therefore converging. Since 2006 risk premiums for investments in Africa has decreased by 1.3 percentage point.

Private sector business activity has also benefitted from more credits supplying the financial markets in Sub-Saharan Africa. There is a consistent pattern of more credits to the private sector in most countries in the region (see Figures 13 and 14), a pattern which has followed along the development of credit markets in other parts of the world. But compared to OECD-countries and countries in Asia, banks do not appear to play an important role in this development. Domestic credits offered by banks have not grown in a similar way, which indicates that other lending institutions take a more active role in this region. We return to this subject in chapter 5 where we focus on obstacles to SME growth.

In the more recent growth literature, the understanding of sources of economic growth is further refined by focusing on the potential differences between public and private investment. Buton & Sumlinski (2000) use investment data from 1970 up to 1998. The data shows a strong positive correlation between investments and GDP growth. However, differences in growth rates are more correlated with private than with public investments, as seen in table 1 below.

**Figure 12: Decomposing GDP growth (excluding trade balance) in Sub-Saharan Africa**



Source: World Bank Development Indicators

**Table 1: Investment as share of GDP in Sub-Saharan African Countries**

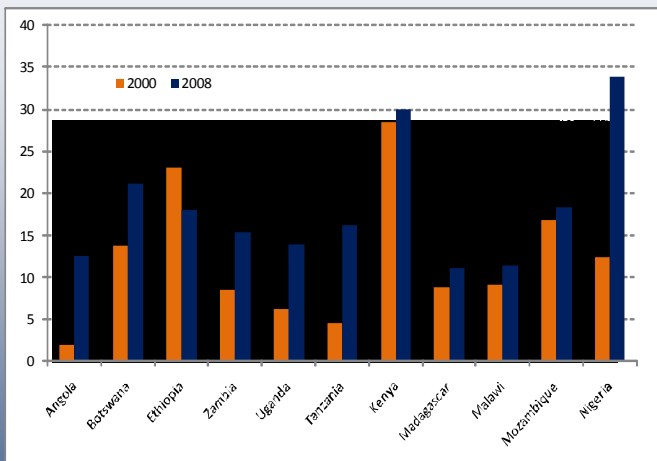
Countries with growth rates	High ( More than 5 percent)	Middle (Between 3% and 5%)	Low (Less than 3 percent)
<b>Total investment</b>	25.3	19,9	18,8
<b>Private investment</b>	17.5	12.2	9.2
<b>Public investment</b>	7.8	7.8	8.7

Table 1 shows that differences between groups are quite small with respect to public investment. Growth could therefore to a larger extent be explained by private rather than public investment.

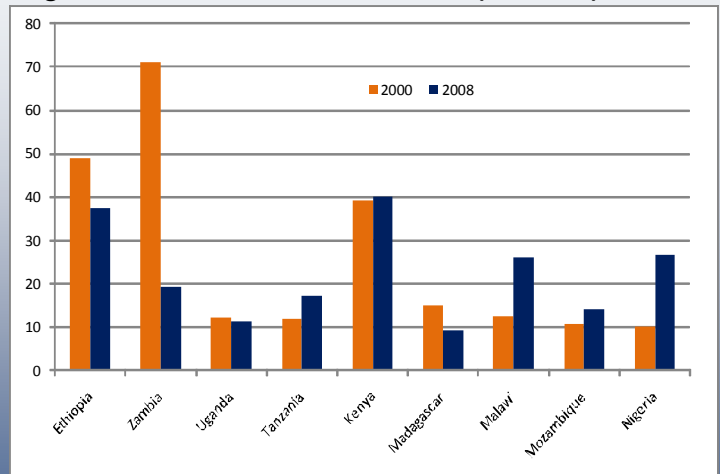
The results indicate that investments in developing countries, either domestic or through FDI has a positive effect on growth and that channelling resources to private investment actually leads to higher growth than channelling resources to public investments. Buton and Sumlinski (ibid) however point out that investment to some extent is an endogenous variable. Improved business environment tend to promote higher private investment. Despite the endogeneity, there seems to be little doubt on the positive relationship between investments and growth, which is also clearly indicated in Figure 12. Private investment and private consumption are the most important contributors to growth during the last years.

The informal sector in many Sub-Saharan countries represent between 40-60 percent of GDP. The informal sector consists mainly of small merchandise traders, selling and producing services, simple manufactured goods and processed food and beverages. In other words, the informal sector in these countries contains

**Figure 13: Domestic credits to private sector (% of GDP)**



**Figure 14: Domestic credits from banks (% of GDP)**



Source: World Bank Development Indicators

the vast majority of SMEs. This is a vital element to remember when discussing the role of SMEs for Sub-Saharan economic growth.

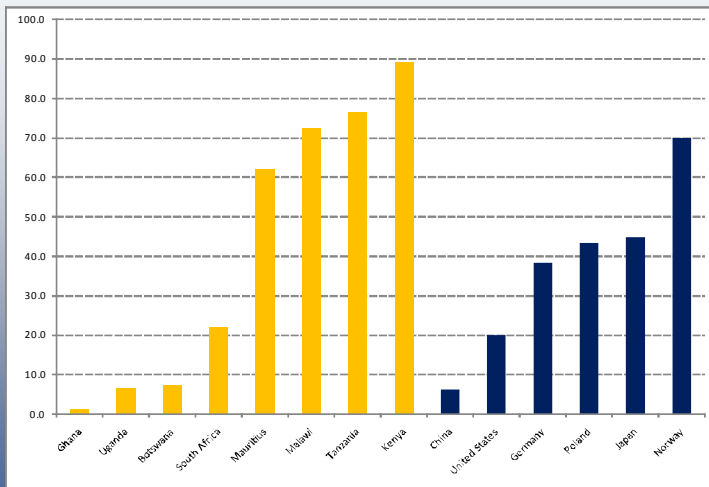
#### 4. The role of SMEs in economic development: Service provision, specialization and industrial dynamics:

Despite the fact that 99 percent of all firms in developing countries are SMEs, and despite the substantial amount written about the significance of SMEs to developing economies, there is very limited evidence in the literature on the contribution of SMEs to economic growth. To a certain extent, this is reasonable. To discuss a class of firms that represents such a big share of the economy, and contrast it with the few large enterprises, is not necessarily easy. The SMEs are present in all sectors, representing a wide variety of firm sizes, technology levels, degrees of formality etc. Below, we point out some broad features relating to SME activity in Sub-Saharan Africa. We provide three possible mechanisms through which SMEs may contribute to growth, and we illustrate our discussion with a few relevant cases.

According to data from the World Bank, many of the countries in Sub-Saharan Africa report a high number of SMEs in the economy. As seen in Figure 16 and Table 2 there is a large difference between regions and countries with regard to the number of SMEs. The variation between countries in the region of Sub-Saharan Africa is large and data uncertainty is high. The number of SMEs is highly dependent on how you define them and whether or not you include the informal part of the economy (not included in Figure 16). We would like to stress three important observations:

First, notice that smaller countries normally have a larger SME sector, in terms of the number of firms per inhabitant. This is exemplified by e.g. comparing Norway with Germany or the US. The reason behind this pattern is probably due to smaller economies of scale on the national level in smaller domestic markets.

Figure 16: Number of SMEs per 1000 inhabitants



Source: World Bank

Table 2: SME share of employment

Country	SME share of employment
Malawi	39 %
Kenya	38 %
Zambia	37 %
Ivory Coast	33 %
Tanzania	32 %
South Africa	21 %
Burundi	20 %
Cameroon	19 %
Zimbabwe	15 %

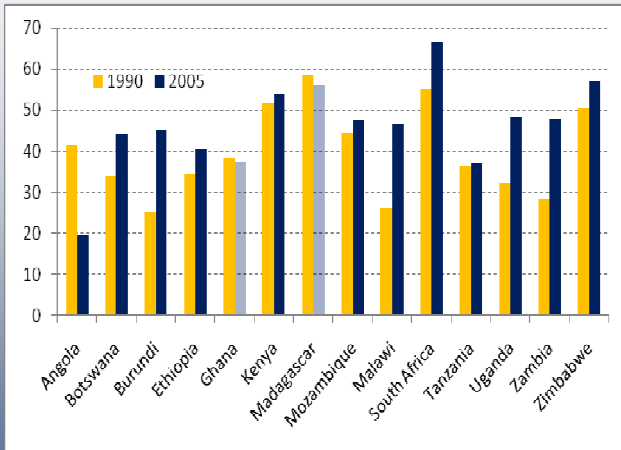
Second, the number of SMEs in an economy is not necessarily related to the level of economic development. In many African countries, activity is distributed widely among a large number of more or less formal SMEs, while e.g. in China, economic activity is to a much larger extent organized in larger entities, both within manufacturing, agriculture and services. Hence, the number of SMEs in a developing economy is to a large extent determined by institutional factors.

Third, the number of SMEs in the economy does not necessarily say much about their contribution to the overall economy. According to Ayyagari, Beck, and Demirgüç-Kunt (“Small and Medium Enterprises across the Globe: A New Database” World Bank Policy Research Working Paper 3127, August 2003) the SME sector’s contribution to both employment and GDP shows a strong positive correlation with GDP per capita. Consequently, the wealthier a country is, the more important are the SMEs in the overall economy. Furthermore, they show that there is a significant negative correlation between the proportion of employment and GDP generated by the informal economy and GDP per capita. In other words, the fact that many countries in Sub-Saharan Africa struggle with a large informal sector, may both trigger a large number of SMEs and a low level of wealth (GDP per capita).

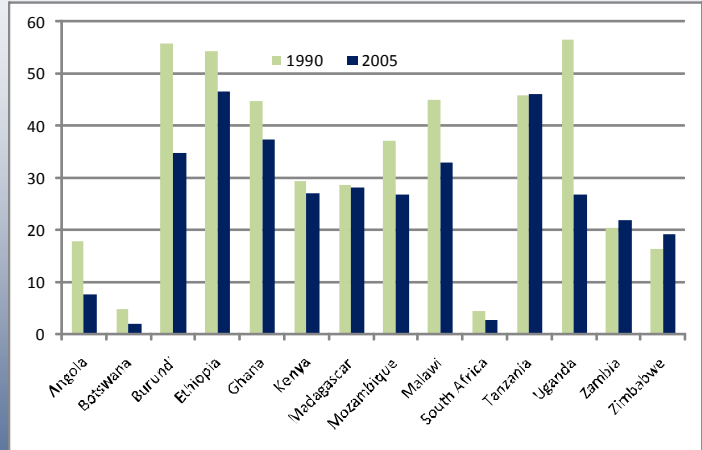
Table 2 contains figures for employment in SMEs as a proportion of the total official labor force in various countries in Sub-Saharan Africa contained in a more recent report by the same authors (“SMEs across the globe”, in Small Business Economics 229(4), December 2007). More recently, Admassu Tadesse, Executive Vice president of the Development Bank of Southern Africa, stated that “in most African countries SMEs in the formal sector contribute less than 20% to gross GDP whereas the figure can reach up to 60% in high income countries.

It seems that SMEs first start to drive economic growth when levels of income start to climb. In this way, the role of SMEs in economic growth and development becomes highly important when a country is set on track along a development path based on persistent economic growth.

**Figure 17: Services as share of GDP (percent)**



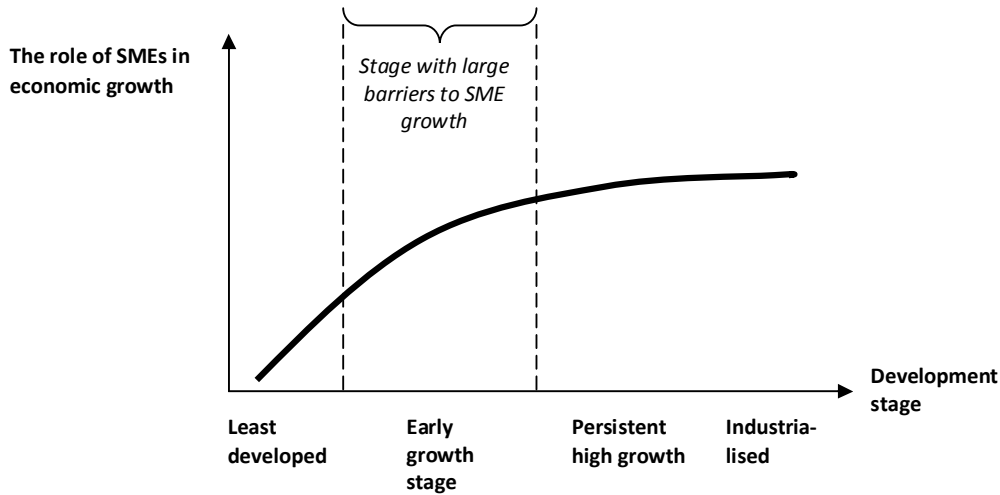
**Figure 18: Agriculture as share of GDP (percent)**



Source: World Bank



Below, we present a simple model that illustrates the role of SMEs in moving from an underdeveloped stage to a path of persistent and high growth and industrialization.



As outlined above, evidence points to a pattern where SMEs start playing a particularly important role when an early growth stage has started to materialize. Below we discuss three mechanisms that may explain this pattern.

**Reduced informal sector and service sector growth**

As outlined above, the informal sector in the Sub-Saharan economies is still large, containing the majority of SMEs. As developing economies grow, the service sector is gradually enlarged by two effects. First, economic growth increases both household and business sector demand for services like transportation, utilities, trade, personal services and business services. Second, a growing economy is also giving rise to incentives for firms moving out of the informal sector as growth potentials outside the most local markets are enlarged. In Figure ZZ, it is clear that over the last two decades, service sectors in the Sub-Saharan economies have grown substantially as a share of overall production in society.

This is a clear indication of economies becoming less underdeveloped and more formalized. Lake et al. (2010) show that this shift towards services has been broad based, registering substantial growth in several service sectors in most countries in the region. This supports the perspective that SMEs play a pivotal role in the formation of a stronger service sector.

**Growth and specialisation**

So far we have shown that growth in Sub-Saharan Africa to a large extent can be ascribed to increased investment, more favourable raw material prices and slightly improved business environment. Growth in a globalized world is normally based on specialisation. Producers of agricultural products and raw materials will search for productivity improvements in order to increase competitiveness. One way of achieving that is to source inputs from more efficient producers, either

domestically or internationally. Large companies outsourcing supporting activities allows for growth in the SME segment.

Improved international regulations and business environment in several developing countries has made it possible to source production facilities abroad (e.g. to Sub-Saharan Africa). This has led to a remarkable increase in foreign trade the last decade, where Asia is being established as a region for low and medium tech industrial production. Africa's export of manufactured goods has also increased, but in a much lower scale. However, in low tech industries such as textiles, manufactured goods and processed food and beverages there has been a substantial increase in exports, as shown in Broadman et al (2006). According to Gelb, Ramachandran and Shah (2009), many of the manufacturing plants in countries like Ghana, Kenya, Mozambique and Uganda are just as efficient as their competitors in China and India.

As pointed out by e.g. Luetkenhorst (2004), fast growing SMEs in developing countries often tend to operate in tight relationships with larger companies. This phenomenon is by no means unique for developing countries. Still, it must be considered when mapping the role of SMEs, most notably because the role of SMEs must be understood in terms of the industrial composition of a country. The dynamics of corporate change involving SMEs will be strongest in the large and more developed sectors.

### **Contribution to industrial dynamics**

In a transition from a strongly raw material and agriculture based economy to a more diversified economy, resources have to be shifted from the old traditional sectors to new sectors supporting demand for services, manufacturing products etc. This process is normally driven by the emergence of new establishments supplying the new demand in competition with older companies.

Under such circumstances, the size of firms often represents an important factor for their success because it allows them to be more flexible than larger firms. Many of them are unproductive and will die out, but some of them are in the lead of transferring resources to new sectors.

If we take Norway as an example, about 60 percent of small companies (1-20 employees) actually die within 5 years. However, during this period a large share of the companies have grown out of its category, employing between 20 and 100 persons. A very small share, 0.2 percent, display exceptional growth and employ more than 100 after 5 years. Though 0.2 percent is a quite small share, these company's contributions to employment and value-creation is substantial and they are found almost exclusively in the new and emerging sectors (e.g. ICT).

## SMEs in Sub-Saharan Africa: Some successful examples



### Successful SME in Malawi:

In 2006, a cow on Matola's small dairy farm in Blantyre was struck by a particularly serious fever. In a desperate search for the drugs that would save his animal, Matola rushed to the local veterinary shop, only to find it shut. The cow survived, but the experience made him wonder about opening his own veterinary shop. Cliff did open a shop, and today sells a variety of drugs, wound cleaners, and feed mixes for cows, chickens, pigs, dogs, and other animals. He invested most of his own capital in the business, but soon needed a fresh injection of funds to expand his stock and satisfy a growing number of customers.

In 2008, Cliff borrowed 500,000 kwacha from NBS bank. "Without this loan, it would have been impossible to grow my business," Matola said. "Now we have all the stock we need and we aren't running out...I don't want another farmer to suffer the way I did when I almost lost an animal."

### Successful manufacturing SME in Zambia

Modi and Miriam Chapotamo process Yatu tea at their tea factory in Ndola which they established in 1999, after selling many of their personal possessions in order to buy the factory. The Chapotamos attended trade fairs throughout southern Africa, where they interacted with buyers and gained a greater understanding of the business process.

During its first full year in business, the factory processed three blends of tea and produced 900–1,000 packages a day. The Chapotamos have big goals for their company and are hoping to increase their output throughout Zambia and eventually move into the export business.





### Successful MNE in Ethiopia

Tariku Midergo started a coffee processing project with family support in 1998 near Yeragalem town in Ethiopia's Southern Nations, Nationalities People's (SNNP) Region. While establishing his business, Midergo heard about a new USAID-sponsored loan program and approached one of USAID's partner banks, the Bank of Abyssinia, participating in the Development Credit Authority program, to get capital to establish and expand his business. Tariku approached the Bank of Abyssinia for a loan in the early stages of establishing the business and was given a loan of Birr 5,000,000, approximately US\$371,727, which he used for operations and capital investments. The Tariku Midergo Coffee Company now has 280 seasonal and permanent employees.

Tariku is now planning to acquire his own coffee farms to increase and ensure his supply of coffee, and then expand his processing operations to take advantage of opportunities for coffee exports under the US African Growth and Opportunities Act Program (AGOA).

### Successful Natural resource SME in Uganda

Kalebu was founded in 1993. The company started as a drilling contractor and then, working with a community on the outskirts of Kampala, it built a small pumped supply serving coin-operated public tapstands. These tapstands automatically dispense a pre-measured quantity of 20 litres when the coin is inserted. In 2001, the company won a contract for water services to five small towns with an average population of 40,000 whose number of private connections varied from 170 to 250. The systems function independently of each other, with a team of about six employees per centre, although their accounting methods and procedures are the same. The technical results are good, with a billing rate of 98% and a recovery rate of around 90% of the amounts due.



## 5 Barriers to SME growth in Sub-Saharan Africa

What are the main barriers for growth in general and SME growth in particular in Sub-Saharan Africa? In this chapter we show that access to proper financial mechanisms and to stable supply of electricity are the main obstacles for business development in the region.

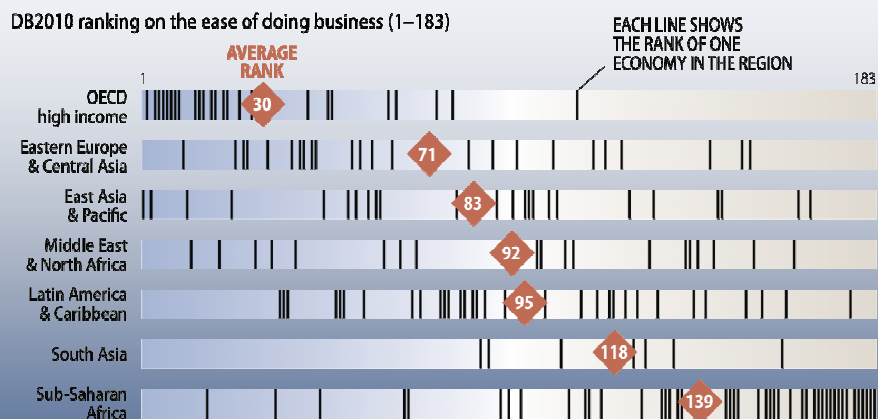
### 5.1 What are the main obstacles to business development in Sub-Saharan Africa?

In order to measure the environment for business development in different countries and regions, the World Bank each year conducts two worldwide surveys. The newest and perhaps most well known is the "Doing Business Index". The index is measuring how public regulations are adjusted to starting and operating business. For instance the index is measuring how long time and how much it cost to register a company, hiring workers, getting credit, dealing with contractual permits etc. Economies are each year ranked with respect to how easy it is to do business. Ranking in different regions of the world are presented in Figure 19

Sub-Saharan Africa is ranked as the region in the world where it is most difficult to do business. We do however find reason to moderate this picture. As shown in Figure 19, the region is also hosting countries with a relatively healthy business environment. For instance, Mauritius is ranked as number 17, well above the OECD-average and South Africa is ranked as number 34, better than countries such as Portugal, Spain and Luxemburg. On average however, Sub-Saharan African countries are scoring poorly. As seen in the figure, countries in the region are over-represented in the low end of the scale with countries such as The Democratic Republic of Congo, Chad and Burundi at the bottom of the scale.

Having said this, business environment in several African countries has improved substantially over the last decade, as pointed out in "Doing Business 2010".

**Figure 19: Ease of doing business. Ranking in different regions**



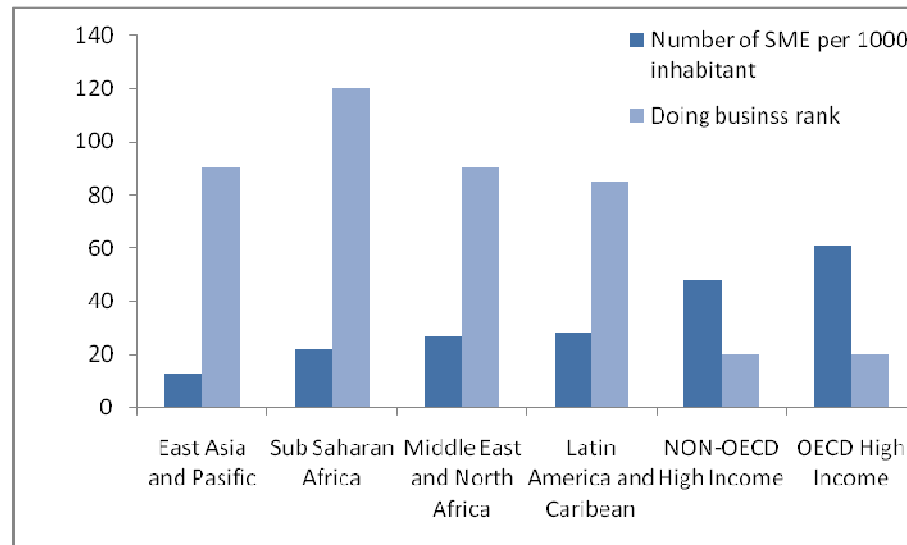
Source: Doing Business database.



According to central studies, improved business environment is a crucial explanation behind strong economic growth in Africa the last decade (Moyo 2009, IMF 2010).

Interestingly, there seems to be a close correlation between the doing business rank and number of SMEs per inhabitant. In Figure 20, we report this pattern. The IFC (2006) has shown that there is a correlation between the well functioning of the business environment and number of SMEs per inhabitant.

**Figure 20 Business environment rank and number of SMEs**



Source: IFC (2006)

A higher business environment rank, goes hand in hand with a larger number of SMEs per inhabitant. However, there are certain regulatory elements that are more important to the SMEs than others. The IFC (ibid) has shown that the total number of days is negatively correlated with SME density. Red tape associated with starting a business would have a strong relationship with SME density, as the process to start a business is the very first hurdle that new entrepreneurs face. In addition to business start up, regulations on hiring and firing is of vital importance to the SMEs in developing countries. Many SMEs struggle with developing a steady flow of business, especially within their first year. As such, constraints on hiring and firing employees can limit entrepreneurs' abilities to adjust to their workflow. Without the ability to easily fire employees, entrepreneurs may opt against expanding their labour force rapidly, even if market conditions generate a demand for more labour.

In addition to the "Doing Business Index", the World Bank is also conducting the "Enterprise Survey". In this survey, more than 100.000 enterprises in 123 countries are asked to fill in a survey on what they consider to be the most important obstacles to performance in their businesses. Among the most important factors we find access to credit and availability of crucial infrastructure such as water and electricity. The 10 main obstacles to business activity in Sub-Saharan Africa are presented in Figure 21.

Electricity and access to finance is considered by far the most importance hindrance by businesses in Sub-Saharan Africa. While electricity is considered the most important by close to 25 percent, access to finance is ranked as the most important hindrance by about 18 percent. Sub-Saharan Africa is in this regard to some extent diverging from other regions of the world where there is a more equal weighting among the categories that businesses consider. Africa is the only region where electricity is considered the most important hindrance. Below, we discuss whether these hindrances have different effect on small, medium and large sized businesses in the region.

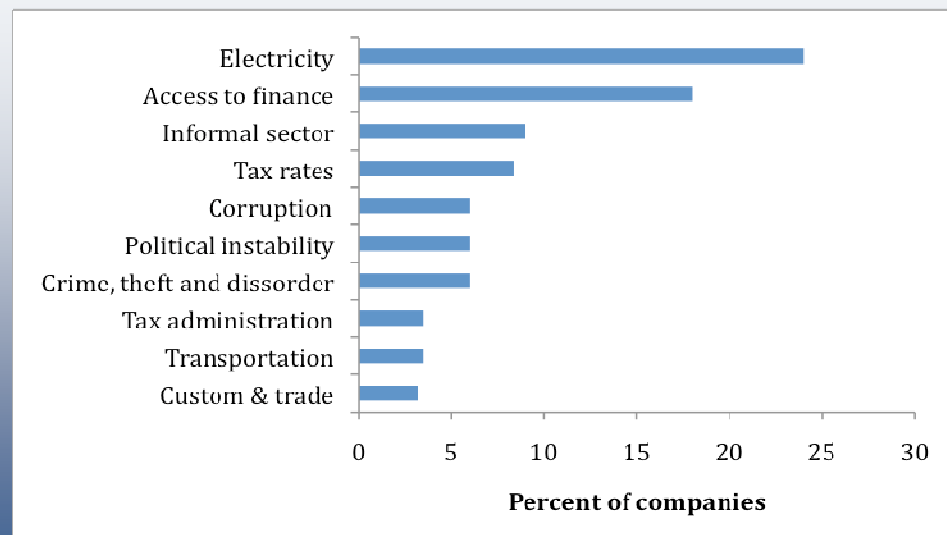
## 5.2 Access to finance and competent capital

The World Bank report “Making Finance Work for Africa” (2006) shows that there is a correlation between access to private credit and GDP per capita. As seen in Figure 23 access to finance is better the higher the level of GDP per capita. The importance of a well functioning financial system for growth and economic dynamics in the business sector can be summarized in the following points, as shown by Rajan & Gleacher (2007):

The availability of external finance is positively associated with the number of start-ups—an important indicator of entrepreneurship as well as with firm dynamism and innovation.

- Finance is also needed if existing firms are to be able to exploit growth and investment opportunities and to achieve a larger equilibrium size.
- Firms can safely acquire a more efficient productive asset portfolio where the infrastructures of finance are in place, and they are also able to choose more efficient organizational forms such as incorporation.

**Figure 21: Ten business environment constraints for companies in Sub-Saharan Africa**



Source: World Bank Enterprise Survey 2010

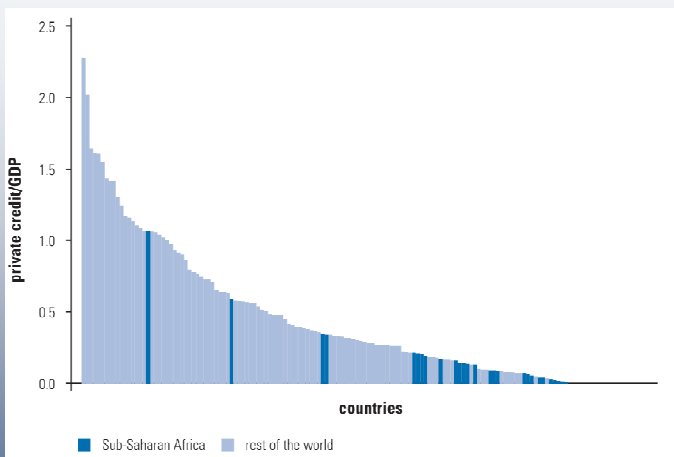
A functioning financial system is therefore of vital importance both with respect to growth of the business sector and overall economic growth and poverty reduction, as show by Sachs (2005) and de Soto (2001) amongst others. As seen in Figure 13 and 14 in chapter 3, access to credit is lower in countries in Sub-Saharan Africa than in other regions of the world. Countries in Sub-Saharan Africa are over represented in the lower end of the scale. This is consistent of what businesses in Africa consider to be their most important hindrance for business operation and development.

The effect of access to finance varies depending on size. In small and young companies, investment is often more risky. Consequently, access to low risk collateral is naturally lower than for older and well established companies. Access to finance is therefore normally better in larger companies compared to SMEs. This is the case in all regions of the world.

However, according to figures in Table 3, only 25 percent of small businesses in South Asia consider access to finance as their major constraint, while the same number for Sub-Saharan Africa is close to 48 percent. The figures show that SMEs in South Asia has better access to finance. While 24.3 percent of SMEs in South Asia has a credit line or loan in a financial institution, the same number for SMEs in Sub-Saharan Africa is 16.2 percent.

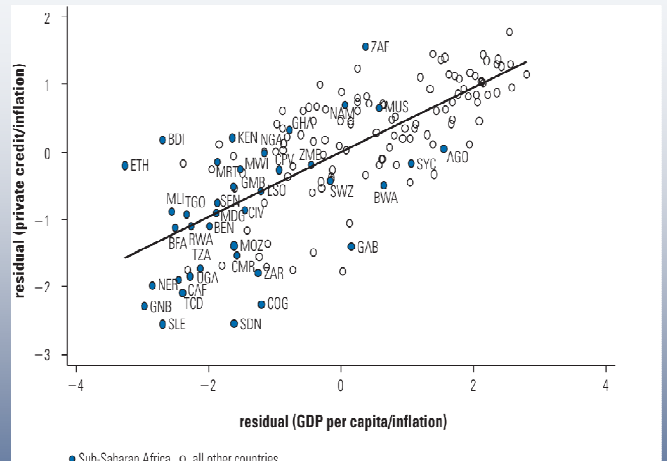
As seen in Figure 24, there is a “missing middle” with regard to access to finance. Micro enterprises in Sub-Saharan Africa have some access to finance through microfinance, personal loans and moneylenders. These sources of credits are more limited for the SMEs (larger than micros). The problem of the missing middle appears to be especially pronounced in Sub-Saharan Africa where the banking system plays a less pronounced role in fuelling the domestic business sector with credits than in other countries.

Figure 22: Private credit across countries



Source: World Bank

Figure 23: Access to finance and GDP per capita



Source: Making finance work for Africa (World Bank)

### 5.3 The role of the informal sector

Due to corruption and red tape many SMEs find it more profitable to stay in the informal sector, and by that avoiding heavy taxation and other burdensome regulations. These informal companies are often well adjusted to the conditions in the informal economy, and unless conditions for operating in the formal economy are substantially improved, it remains profitable for them to stay in the informal sector. However, growth opportunities in the informal sector are seriously hampered by reduced access to formal credit, lack of possible expansion out of local markets etc.

Despite being less productive than larger companies, small firms in the informal sector are found to be better adjusted to a weak business environment. Aterido et al. (2009) find that weak a business environment displaces activities from large, medium and small companies to the benefit of micro companies, implying that resources are allocated from productive companies to less productive companies. Shifting activities from the micro to the small, medium and large companies would not only increase productivity, but also increase tax revenues. Finally, shifting activities from the informal to the formal sector will allocate more resources to training and R&D, since larger companies invest more in such activities.

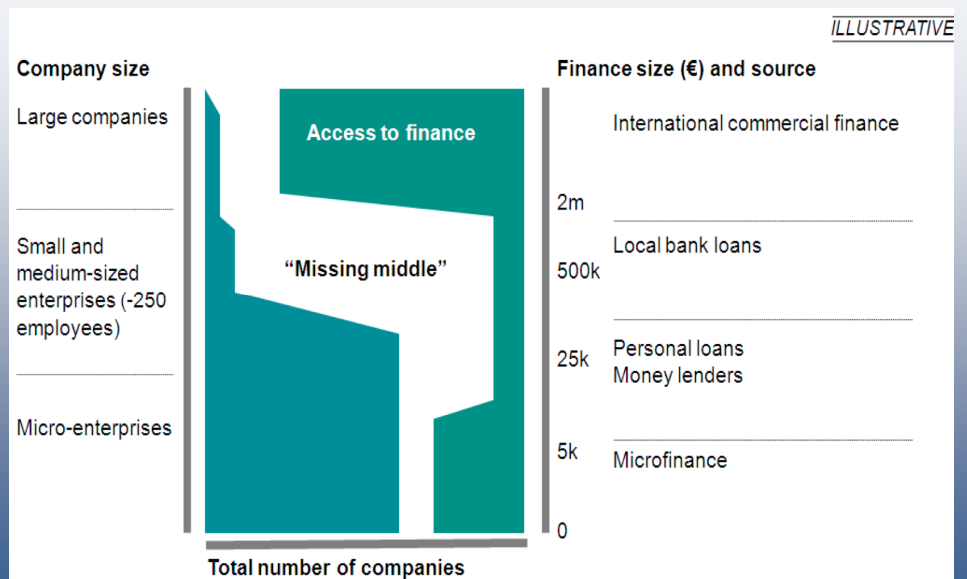
Improving business environment is the obvious way to reduce incentives to stay in the informal sector. By reducing red tape, removing corruption, securing property rights, reducing inefficient taxes and last but not least improving access to electricity is the best way to increase incentives for SMEs to enter the formal economy. However, improving overall business environment is timely and can only be done by ownership to the process by host country government. While waiting on the business environment to improve, it would give good development effect to increase incentives to enter the formal economy by increasing access to equity capital.

**Table 3: Access to finance in South Asia compared to Sub-Saharan Africa. Variations depending on size**

		Small	Medium	Large
South Asia	% of companies identifying access to finance as their major constraint	25.2	24.0	17.7
Sub-Saharan Africa	% of companies identifying access to finance as their major constraint	47,9	41,1	34,2
South Asia	% of companies with line of credit or loan form financial institutions	24.3	39.1	57.8
Sub-Saharan Africa	% of companies with line of credit or loan form financial institutions	16,2	31,9	46,5

Source: World Bank Enterprise Survey Database 2010.

Figure 24: The missing middle in financial support





### 5.4 Access to electricity

As seen in Figure 21, electricity is by far the most important obstacle that most businesses in Sub-Saharan Africa experience when operating and developing their business. This problem is strongly related generator capacity in the region, as shown in Figure 25.

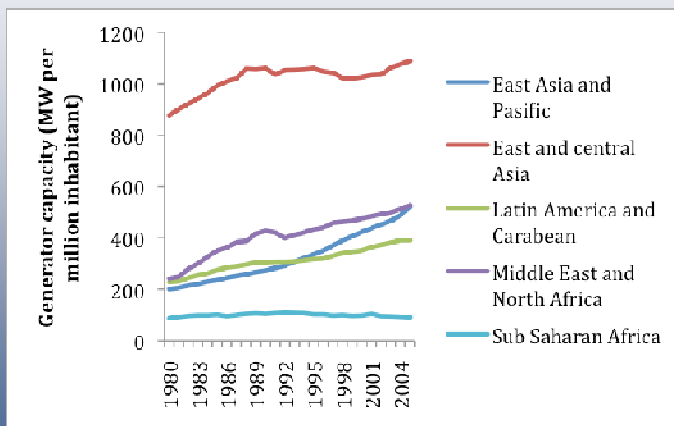
Generator capacity per million inhabitants has been stable in Sub-Saharan Africa while increasing in all other regions in the world. Lack of electricity supply and electricity reliance combined with growing energy demand has driven up prices. Prices of electricity in Sub-Saharan Africa are in line with prices in the OECD area, making electricity almost twice as costly as in Latin America and Eastern and Central Asia (see Figure 26).

In addition to a critical lack of investment in energy production, investment in transmission lines has been lagging severely. Overexploitation of transmission lines causes large problems of power outage. In addition to high prices of electricity outage represents a serious problem for businesses in Sub-Saharan Africa. Youpes et al (2008) has shown that in periods where outage is frequent, economic growth is slowed down. They estimate that annual GDP growth would have been 1-2 percentage points higher if access to electricity had been more stable. This is a large and substantial effect in macro. Investments in electricity production and transmission lines would therefore contribute significantly to boost growth in Sub-Saharan Africa.

As seen in Table 5 more than 50 percent of businesses in Sub-Saharan Africa identify electricity as their major constraint. In contrast to the results on access to finance, these problems seem to hit larger businesses more severely. The reason for this may be that larger companies are more often involved in energy dependent manufacturing activities.

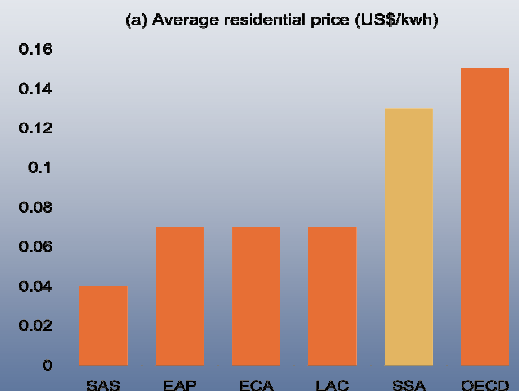
However, as shown in the table, loss due to power outage is higher in smaller than larger companies. Since power outage might cause serious long-term problems, larger companies have to larger extent invested in alternative power

Figure 25: Generation capacity 1980-05 in the regions of the world



Source: Youpes, Pierce & Foster (2008)

Figure 26: Average residential price (US\$/kWh)



Source: Eberhard and others (2008).

sources such as diesel aggregates. Although this provides more stable access to energy, it increases production cost. Therefore average time of power outage is less in larger compared to smaller companies.

As in the case of finance, Aterido et al. (2009) found that lack of access to electricity actually benefits micro companies. Weak business environment in this field contributes to allocation of production resources to the least productive sector of the economy, which in turn affects productivity, tax income and growth.

In order to improve access to electricity, large investments have to be made in electricity production and transmission. Better regulation and public purchase agreements must be put in place in order to boost investment. When such regulations are in place, investments in electricity production in Sub-Saharan Africa should improve the business environment significantly since access to electricity is considered their most important obstacle to business activity.

**Table 5: Electricity obstacles depending on firm size in Sub-Saharan Africa (2008)**

	Small	Medium	Large
% of firms identifying access to defining electricity as their major constraint	50	51	57
Loss due to power outage	6	5.6	5.5
Average time of power outage per month	68.1	73.4	64.8

*Source: World Bank Enterprise Survey*

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**Table 6: Roles, responsibilities and issues in relation to different source of finance for SMEs in Sub-Saharan Africa**

Financial instrument	Role for SME	Role for Financial institution	Role for Government	Potential roles for international agency	Issues
Overdraft facility or bank loan	<ul style="list-style-type: none"> <li>• Need to be able to offer collateral in form of equity, land, property or moveable assets</li> </ul>	<ul style="list-style-type: none"> <li>• Establish specialist SME department</li> <li>• Develop risk assessment capability</li> <li>• Develop lending policies based on moveable as well as fixed assets</li> <li>• Mortgage lending to enable entrepreneurs to use property as collateral</li> </ul>	<ul style="list-style-type: none"> <li>• FIs require legal system to be strengthened to enable them to increase credit recovery and reduce defaults</li> <li>• Credit Law (requiring banks to share information on customers with credit bureau) and set up Credit Bureau to independently assess risk</li> <li>• Establish bond market to mobilise long term financing</li> <li>• Establish property rights/security of title</li> <li>• Mortgage Finance Law</li> </ul>	<ul style="list-style-type: none"> <li>• Investment in banks or credit bureau linked to training for staff</li> <li>• Support for drafting Credit Act</li> <li>• Mortgage Toolkit for FIs (IFC)</li> <li>• Support establishment of bond markets</li> </ul>	<ul style="list-style-type: none"> <li>• Bank loans to SMEs in Africa are typically more expensive, shorter term and more difficult to obtain than in other developing countries</li> <li>• Banks are reluctant to lend to SMEs due to high risks of default, lack of professional management in SMEs, poor risk assessment capability</li> <li>• FIs require access to long term fixed/low interest finance to enable on-lending at a profit</li> <li>• Concerns about confidentiality of credit bureau, etc</li> </ul>
Leasing	<ul style="list-style-type: none"> <li>• Willingness to lease rather than buy</li> <li>• Recognition of need for quality/reliability of products leads to demand for new/better equipment</li> </ul>	<ul style="list-style-type: none"> <li>• Development of and funding for leasing companies</li> </ul>	<ul style="list-style-type: none"> <li>• Leasing Law which removes legal constraints that hamper repossessions</li> <li>• Change tax rules where necessary to enable lessors to deduct capital depreciation and lessees to avoid tax on repayment of principle</li> </ul>	<ul style="list-style-type: none"> <li>• Investment in leasing companies linked to training</li> <li>• Support establishment of bond markets</li> </ul>	<ul style="list-style-type: none"> <li>• Need to overcome significant legal and judicial constraints</li> <li>• Limited demand due to small SME sector means few companies interested in entering leasing market</li> </ul>