

# Influence of microfinance institutions to smes in tanzania economics essay



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## 1. 0 INTRODUCTION

In most of emerging economies small and medium enterprises (SME`s) are considered important for creating employment and contribution to private sector development they are recognized as they continue to play an important role in economic development of any country due to their ability to raise incomes and creation of jobs in environments with scarce economic opportunities. Furthermore they are considered to be a very important resource for their contribution to eliminate poverty and creating jobs.

Davies, et al (2002) states that, the immediate goal for any small to medium-sized enterprise (SME) is to survive and maintain its independence. But, sooner or later, a small company will probably want to expand. As such, there is a current trend towards global convergence and the adoption of outsourcing by firms of all sizes, growth usually means entering the international market. The aim of this paper is to examine the growth strategies and problem facing most of SMEs, and will investigate the role of strategies on which can be improve growth performance of SMEs.

Among the problems they face is inability to grow. SMEs growth depend to a large extent on the financial assistance obtained internally or externally, internal sources of funds are generated from business operations or fund from owner themselves, due to the fact that most of the time these funds are not enough external finance become important, external sources include, funds from family members or friends, debts financing from financial institutions.

This essay analyses the influence of microfinance to the growth of SME a case study of Tanzania. It is triggered by the thinking that lack of enough fund is one of the hindrance to the growth of SME's

The question explored in the study was to look into the influence of microfinance to the growth of SME in Tanzania. More specifically the hypothesis of the study was to see whether the growth of SME in Tanzania is directly related to the services they obtained from SME's.

As the tools for the study; various framework, theories and models regarding the concept of SME and microfinance are explored, analyzed and conclusion drawn.

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## **2. 0 CONCEPTUAL FRAMEWORK**

### **2. 1 Meaning of micro finance**

Refers to the extension of small amounts of collateral free institutional loans to jointly liable poor group members for the self employment and income generation (Rahman, 2001).

“ Microfinance is bringing credit, savings and other necessary financial services inside the reach of people who are too poor to be served served with normal banks, as yhey are unable to provide adequate collateral.

Generally, banks are for those who have money and not for the people who are without money. (Gert van Maanen, Microcredit: Sound Business or Development Instrument, Oikocredit , 2004)

“ Microfinance is based on the idea that poor people have expertise which are unutilized or underutilized. The lack of skills is not what makes people poor . Aid is not the answer to poverty, but only it helps poverty to continue. It makes dependency and takes away the people’s initiatives to break through poverty. Unleash of creativity and energy in human being is the answer to poverty.” (Muhammad Yunus, Expanding microcredit outreach to Reach the Millennium Development Goals, International Seminar on attacking Poverty with Microcredit, Dhaka, Bangladesh January, 2003)

Microcredit belongs to the group of financial service innovations under the term of microfinance, other services according to microfinance is micro savings, money transfer vehicles and micro insurance. Microcredit is a innovation for the developing countries. Microcredit is a service for poor people that are unemployed, entrepreneurs or farmers who are not bankable. The reason why they are not bankable is the lack of collateral, steady employment, income and a verifiable credit history, because of this reasons they can’t even meet the minimal qualifications for a ordinary credit. By helping people with microcredits it gives them more available choices and opportunities with a reduced risk. It has successfully enabled poor people to start their own business generating or sustain an income and often begin to build up wealth and exit poverty.

## **2. 2 Micro finance institutions.**

Mayoy (1999) has defined MFIs as a sector of formal and informal financial institutions provide financial services to micro economic units. The terms are

used as umbrella terms to refer to the range of services such as credits, savings and other financial services like pension and insurance.

The World Bank (1998), defines MFIs as agents and organisations that engage in relatively small financial transactions using specialized as well as character based methodologies to serve lower income households, micro enterprises, small farmers and others who lack access to the bank's system. They may be informal, semi formal (that is legal registered but not under central bank regulations), or formal financial intermediaries.

### **Micro and Small enterprises.**

URT (2002), defined small and micro enterprises as those lacking access to financial services from mainstream financial institutions. Generally the definition of micro-small business enterprises is extremely diversified in such a way that definition used depends on various measure of size; depend on the purpose and the reasons. Doing the measuring for instance, in United Kingdom the definition of for small could be range from 5 to 2000 employees depending on the industrial sector, (Kibera 1996)

In Tanzania context, small and medium enterprises are those which consist up to four people in many cases family members, The popularity of small and medium enterprise are in informal sector, they are mostly formed by engaging between 5 and 49 employees with te employing capital of 4M to 200M to 800M. (SME Policy 2003).

### **3. 0 MICRO FINANCE DEVELOPMENT IN TANZANIA**

In Tanzania micro finance is in its infancy, but growing fast, in late 1960s after the Arusha declaration, Tanzania government establish financial institutions to assist the poor farmers and small scale enterprises they were NBC and CRDB. Before restructuring, statistics indicates that the informal sector accounted for 80% of non farm employment, (Rutashobya 1991), only 0. 4% or about 8000 people obtained their credit from formal banks, those who obtained their credits from cooperative societies or saving and credit cooperative organisations. A common phenomenon at work place accounted from 03%. Mlowe (1994) concluded that the gap was due to reluctance of most of the existing banks and other financial institutions to lend the rural population and low income earners because of the associated follow up and administrative costs.

Currently micro finance industry in Tanzania is growing fast following 1991 financial sector reforms, which focused on among other things creation of an effective and efficient financial system, that was partly due to the vacuum left by formal financial institutions (since they were serving the urban and people who were already established business), and also due to the recognition of the role of the private sector including the dynamic role of micro and small enterprises (Chijoriga 2001).

Micro financing institutions such as credit granting, provide micro or small loans without collateral at market interest rates or slightly above them to small scale clientele, mostly non farm enterprises, typically, the MFIs enable to extend loans based on the borrower's cash flow and to tailor-fit the loan repayments in accordance with cash flows. It follows the simplest <https://assignbuster.com/influence-of-microfinance-institutions-to-smes-in-tanzania-economics-essay/>

documentation leading mechanisms such as peer pressure, and joint liability groups to ensure borrower discipline, incentives to motivate clients' good behaviour, good loan offers, and threat of cancellation of future loans for defaulting borrowers, among others, (Liento 2003)

### **3. 1 Micro finance institutions currently found in Tanzania**

According to currently literatures, micro finance business emerged in Tanzania either as micro finance institutions or financial NGOs, i. e. FINCA, PRIDE SEDA, and others, also some of the banks do provide micro finance services i. e. CRDB, NBC, ACB and others, apart from them institutions the government also is no left behind on this war against poverty eradication, its provide micro finance loans to its people i. e.

through TASAF, SELF, RFSP, all these institutions and various government programmes work jointly so that to eradicate poverty.

## **SIGNIFICANCE OF CREDIT FACILITIES TO MICRO AND SMALL ENTERPRISES**

Literatures has been indicated that micro finance is potential tool to contribute considerably to the economic development of the country, Tanzania is like many other developing countries and is classified as the poorest nation . according to household budget survey (HBS), the most commonly measure for poverty analysis , depicted that in year 2001/2 about 34% of the population was considered to be poor and 82% of the poor were in rural areas, (poverty eradication paper, 2002). Therefore by extending credit to MSEs will offer so many benefits i. e. creation of employment,

expanding business, improving standard of living, capacities in investing as well as saving to the people in the country hence development of the nation.

#### **4. 1 POVERTY ALLEVIATION AND IMPROVING LIVING STANDARD, EMPLOYMENT CREATION.**

In Tanzania about 75% of households depend highly on informal business and earn their living normally through this type of activity, (Rutashobya 1999), since micro finances and small enterprises tend to be labour intensive, they create employment at relatively low investment levels per job created . presently, unemployment in Tanzania is a significant problem. Estimates show that there about 700, 000 new entrants into labour force every year. About 500, 000 of them are school leavers with few marketable skills. The public sector absorbs only 400, 000 of the new entrants into labour market, leaving about 300, 000 to join the unemployed. Most of those people end up in micro and small enterprises sector, and especially in the informal sector. According to the informal sector survey of 1991, micro enterprises operating in the informal sector alone consisted more than 1. 7 million engaging about 3million person that was about 20% of the Tanzanian labour force. (SMEs Development policy)

#### **5. 0 THEORETICAL FRAMEWORK FOR SMALL BUSINESS DEVELOPMENT**

Over the last few years, many African countries have moved or are in the process of moving toward western type political democracies with their economies from socialist based to capitalist/free market oriented economies.

These transitions however, are not smooth. They are associated with painful

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economic and social consequences. People in third world, most of the time carry the burden of these transitions' consequences. People, i. e. impact of structural adjustment programme (SAP).

As the population increases, the government agencies or large companies will not be able to create sufficient jobs for present unemployed and projected increase in population. It is estimated that 700, 000 people join labour market annually while the formal economy only can absorb 40, 000 people. In this regard the informal sector through the small businesses will be the ones to create the needed jobs for their ever growing population and hence to take advantage of the situation. To get the economies moving on the road to sustainable growth with equity, African countries need to take critical look at the past experience, present constraints and future prospects for small and medium business development. (URT, 2001).

The economic transformation occurring around the globe dictates the emergence of the small and medium enterprises. The market demands for the availability of several differential products makes customized and not mass production to be an appropriate production plan. This can be done via small medium enterprises, (julien, 1998).

Despite micro finance are very important for the development of the nation, in Tanzania it took time to create policy environment that was conducive to SMEs, it was not until the year 2000 that the national micro finance policy was launched by the minister of finance and bank of Tanzania.

## **5. 1 THE ROLE SMES IN THE ECONOMY.**

SMEs are considered to have great potential for making the highest contribution to employment growth through labour intensive technologies to reveal an immediate impact on the employment generation (ILO, 1993 and Kitine 2000). SMEs contributing to increase income, saving and encouragement of business ownership and management at enterprise level. About 70% of people in sub Saharan Africa rely on the small enterprises for their livelihood, (Rutashobya 1995, Masawe 2000).

In Tanzania, small and medium business contributes substantially to the country's GNP and employment in the country (Olomi 2001, URT 2001). However SMEs about 1/3 of the GDP of the country and that about 20% of the labour force is employed by the sector (URT, 2001). However SME sector in Tanzania is not centrally documented to find reliable data on the stated estimates (word bank, 2000).

## **5. 2 Importance of SMEs in Economy.**

SMEs tend to be more effective in the utilization of local resources using simple and

affordable technology, by so doing they add value to local resources,

Tanzania is endowed with abundant of natural resources which are yet to be fully tapped, on the other hand , development of SMEs facilitates distribution of economic activities within the economy and that fosters equitable income distribution . that means SMEs are used as engine of producing indigenous people in the business, and therefore they used to distribute wealth among indigenous people (ACS and Audtresch, 1990)

The importance of SMEs to world economies is well documented . SMEs (firms with 200 or less employees) make up the largest business sector in every world economy ( Wang, c. et al 2000), and governments around the globe are increasingly promoting and supporting SME growth as part of their overall national development strategy. While they dominate in terms of absolute numbers, SMEs are also important because they are key drivers of employment and economic growth. At a macro level, SMEs have created the majority of new jobs in OECD countries since the 1970s (Robertson, 2003) and their collective contributions to respective GDPs.

According to Smallbone, D. et al (1995), at a micro level, SMEs are popularly looked upon by governments as a keystone to regional economic and community regeneration. Since the early 1980s, considerable restructuring particularly in large firms (e. g., rationalizing, downsizing, outsourcing and job exporting) has seen a general shedding of jobs. It is primarily through the growth of SMEs that employees made redundant by large firms have been absorbed back into the work force through a multiplier effect; this employment provides income to regions which stimulates local economic activity which in turn, drives wealth and further creation of employment (Wang, c. et al 2000).

## **6. 0 FINANCIAL REFORMS.**

In Tanzania the banking and financial institution act 1991, marked the beginning of the on going financial reforms, the law among other things permitted entry of private banks and provided the supervision and regulation framework for the financial sector. (Llwiza and Nwako, 2002).

A large body suggest that financial development contributes significantly to growth of the economy, (word development report, 2002). Through its strong effort on overall economic growth, financial development is centrally to the poverty reduction, research done by world also shows that financial development directly benefits the poorer segment of the society and it is associated with improvement in income distribution. (World development report, 2002).

## **6. 1 Introduction to micro finance.**

The term micro finance institution is widely used, it generally address all types of entities engaged in microfinance , micro finance is not a to the African societies . there are many forms of informal and formal saving and loan associations that have been operated traditionally at the village and group level. Modern micro finance scheme, solidarity group, village banking and others, have been operating for twenty years. Micro finance institutions have been involved as effective tool for provision of financial services on sustainable bases to the to the small business sector, but at a very low level of out reach. Only a small fraction of the productive poor have access to even the micro finance services that are available.

Many MFIS are doing well, are doing excellent job of reaching the market providing basic loan services. Micro finance as involved as an effective tool to provide credit on sustainable basis for small business sector, but at a very low level of outreach. Only a small fraction of a productive poor have access to even available services of micro finance. MFIs have become an important financing source for the development of micro entrepreneurs (Hulme, 1999).

And also they have become of an increasing important component of strategies to reduce poverty and promote SMEs development.

## **6. 2 Concept of Business Growth.**

The term of business growth is used in ordinary language to mean two different connotations. Sometimes it meanly means increase in amount ie sales or export. At other times, it is used in its primary meaning implying increase in size, improvement of quality as a result of a process of development (Penrose, 1959).

The business economic performance will reflect its value in the society. The length of the business has been performing in the market can predict its growth stage as indicated in the product life cycle theory (Kotler, 1997).

There are two types of growth, qualitative and quantitative growth. (Olomi 2002). qualitative growth can occur through change or sophistication in the firm and its owner, quantitative growth has to do with changes that are readily measurable, such as work force size, sales revenue, profitability, total investment, product mix etc.

High growth can be achieved by firms with a variety of size, sector and age characteristics. One of the most important factors is the commitment of the leader of the company to achieving growth. To grow successfully over an extended period, firms needed to develop their internal organization structure in ways that enabled the leader of the firm to delegate responsibility for operational tasks and focus more on planning and higher level strategic functions. My analysis demonstrates the importance of recognizing the sectoral Context as a framework for considering the

strategies associated with growth. It is the sector which defines the factor and technology choices, and often the opportunities.

However, the factor that must be recognized in any analysis of growth performance in SMEs is that not all small businesses are growth-oriented (Smallbone, et al 1995). In small firms, where ownership and management are typically combined in one or more individuals, future goals for the business may be determined as much by personal lifestyle and family factors as by commercial considerations. Thus it is not surprising that one characteristic which did distinguish the best performing firms from other firms in the study was their commitment to growth.

Oke, et al (2007) has shown that entrepreneurs create new jobs, increase local incomes and wealth, and connect the community to the larger, global economy. The acknowledgment of the importance of innovation and SMEs has led to the development of the National Systems of Innovation in several countries. For instance, (Birch, 1989) coined the term “ gazelle” to refer to SMEs that have a high growth rate. It has been suggested that SMEs (e. g. “ gazelles”) operating high growth businesses are the engines of the economies and provide the majority of new jobs. What has been lacking in many of the studies in this stream is the important role that innovation plays in fueling such growth in the SMEs.

More recently the EU has begun to focus on entrepreneurship as part of its industrial policy rather than focusing mostly on large-scale innovation.

According to Floyd and McManus (2005) Small firms tend to be more flexible and engage in adaptive innovation that brings further economic benefits.

Product differentiation and lateral thinking help create a broader product range in order to create more choice and employment opportunities. Policies have included advice on exporting as well as money for start up. Information technology training has also been seen as a vehicle for entrepreneurs since small firms tend to benefit from flexible working hours.

### **6.3 Access and outreach of MFIs for SMEs.**

Outreach refers to the extent to which all segments of population including low income people have access to financial institutions and their services. If micro finance is to have a significant impact on alleviating poverty and stimulating the business sector, it has to have wider outreach (Oyer and Levisky, 1999). The emphasis on the accessibility and outreach is highly relevant as far as the question of economic growth is concerned.

According to the research done by Chijoriga (2000) in Tanzania, most of MFIs operate only in the municipalities, cities and towns in which they are registered, showing high concentration in the urban areas; few of these schemes reach rural people. The gap of financing is therefore there, especially for the agricultural sector and in particular for small farmers.

### **6.4 Some of the Problem facing SMEs in accessing credits**

Financing has been identified in many business survey as the most important factor determining the survival and growth of medium and sized enterprises in both developing and developed countries access to finance allows SMEs to undertake productive investment to expand their businesses and to acquire the latest technology thus insuring their competitiveness and that of the national as a whole. Poorly financial systems can seriously undermine the

microeconomic fundamentals of a country, resulting in lower growth in income and employment. Chijoriga (2002)

Despite their dominant number importance in job creation, SMEs traditionally have faced difficulty in obtaining formal credit. I. e. maturities of commercial banks loans extended to SMEs are often limited to a period which is very short to pay off sizeable investment, mean while access to competitive investment is reserved for only few selected blue-chip companies while loan interest rates offered to SMEs remain high. Chijoriga, (2000).

According to Chijoriga, (2000) traditionally commercial banks and investors have been reluctant to service SMEs, for a number of well known reasons some are,

)<sup>3</sup> SMEs are regarded by investors as high risk borrowers due to insufficient assets and low capitalization, vulnerability to market fluctuations and high mortality rates.

)<sup>3</sup> information asymmetry arising from SMEs, lack of accounting records, inadequate financial statements or business plan make it difficult for creditors and investors to assess the credit worthiness of potential SMEs proposals.

)<sup>3</sup> High administrative/transaction costs of lending or investing small amounts do not make SMEs financing profitably business Chijoriga, (2000) . as a results commercial banks are generally biased toward large corporate borrowers who provide better business plans, have credit ratings, more reliable financial information, better chances of success and higher profitability for banks. When banks do lend to SMEs, they tend to charge



them a commission for assuming risk and apply tougher screening measures which drive up costs on all sides.

Many researchers and practitioners attribute “ Poor Management” as the major cause of small business failure. Whether the causes are labeled as financing, competition, marketing, inventory, etc., they can be safely avoided if good management was in place. Although it has become difficult to explain what constitutes “ poor management”, small business owners/managers need to develop basic managerial skills and knowledge Temtime, T. Z and Pansiri, J. (2006). If they are to succeed, managers need to have sufficient skills in the area of planning, organizing, directing and controlling organizational resources. The respondents have clearly known the importance of managerial adequacy and competency as critical success factors. Managerial competency is measured by seven factors.

The main contributor to the critical role of the managerial factor is the use of external advisors, focus on strategy formulation and implementation rather than focusing on operational bits and pieces, aiming for long term competitive advantages rather than short-term profits, and developing strong interest for non-financial benefits such as need for achievement and recognition Visagie, J. C. (1997). Most SMEs in developing economies lack strategic orientation and long-term vision. They put greater emphasis on short-term profits rather than building long-term competitive potential.

## **7.0 PRACTICAL REVIEW BASING ON TANZANIA PERSPECTIVE.**

Because the study aiming at studying the influence of MFIs on the SMEs growth, it is important to understand MSEs growth achieved by different MSEs owner managers in various countries,

### **)<sup>3</sup> Kashf, Pakistan**

Is one of micro finance institution operates in Pakistan. In the study on influence assessment of kashf's micro finance and kanan enterprises development programme, conducted in 2000<sup>1</sup> arjumand and associate consultants. They surveyed 2000 Kashf clients as well as a comparison group of non clients; non clients were similar to clients in most respect except that 40% were salaried workers, compared to only 16% of kashf clients, and however their initial incomes were nearly identical. One year later kashf clients increased. At the time of survey, US\$ 1 was equivalent to 59 rupees (oanda. Com), measuring the influence of micro finance average income by 31% to rupees 7039 versus rupees 6206 for the comparison group. The report specifically states that kashf " focuses on the working poor as opposed to people who were employed" it is the poorer of kashf's clients that showed the strong impact. The poverty among kashf members decreased by 20%

)<sup>3</sup> According to paper presented in world export development forum in Switzerland, October 2007 basing on Tanzania as a background country stated that, in Tanzania the SME sector is prime mover of economic undertakings but is still facing a number of problems, financing investment in Tanzania is a major constraint. Adequate finance is not being provided to <https://assignbuster.com/influence-of-microfinance-institutions-to-smes-in-tanzania-economics-essay/>

allow for the development of the sector due to the fact that banks do not cooperate with SMEs, some banks operated in limited areas, lack of adequate guarantee schemes to back up banks financing SMEs, technology transfer and advancement are recognised as important aspect for SMEs development.

## **7. 1 CONTRIBUTION OF MFIS TO THE IMPROVEMENT OF HOUSEHOLDS' INCOME**

According to the Littlefield (2003), MFI is an attractive development strategy, which finally leads to help poor population, the potential for reaching and assisting large numbers of households on sustainable basis made MFIs a popular development investment in 1990s. Today there are thousands of MFIs programmes established with benefit of development funding.

Guli (1998) points out that micro finance should be seen as the provision of small scale financial services to business and household traditionally kept outside the financial system rather than more narrow view of micro finance as services for the poor micro enterprise owners

## **8. 0. CONCLUSION**

SMEs continue to play an important role in the development of world economies however they continue to face enormous challenges to grow and develop as compared to rival bigger firms. But it is pleasing to note that of late major financing institutions like the EU and World Bank etc and mostly developing countries are coming up with deliberate policy that will fuel the development and growth of SMEs as their existence has proved worthwhile

to the development of various economies through poverty reduction as they continue to be a major source of employment.