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## Assessments of Growth of Micro and Small Enterprises (MSEs): A Review of Empirical Evidence from Ethiopia

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### Abstract

Global based growth and transformation through the promotion of micro and small enterprises (MSEs) has been robustly underscored in various development plans in Ethiopia, but both the levels of unemployment and quality of jobs remain a concern. The main objective of this study was to review related literature of the Determinants of growth of micro and small enterprise, identify the gap based on the review of the literatures and finally concluding and recommending based on the reviewed papers. The findings of the study reveal that MSEs suffer from a host of internal problems (e.g., Weak human resources and other assets) and external factors, including lack of access to credit, limited market facilities, policy and regulatory bottlenecks. For small enterprises, access to credit appears to be a binding constraint for their growth as they are 'too big' for micro financial institutions, but they are 'too small' for formal banks in terms of the size of loan, reflecting the 'missing middle financial intermediaries' that serve small enterprises. Hence, without a renewed focus on promoting firm growth, especially MSEs through improving access to warehouses, relaxing credit constraints, and improving the macroeconomic and regulatory environment, the potential for MSEs for creating more jobs will be severely compromised.

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### Keywords:

Microenterprises;  
performance;  
learning model;  
firm size;  
Ethiopia.

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### 1. Introduction

Many countries in Africa suffer from high rates of unemployment and under-employment and low labor productivity. In addition, because of demographic factors, a large number of people enter into the labor market each year (Leonardo Iacovone, 2012). Consequently, these countries have been promoting job creation through a variety of means such as targeting labor-intensive manufacturing industries, promoting labor-intensive infrastructure, expansion of micro and small enterprises (MSEs), and education expansion (e.g., Technical and vocational education and training, etc.) (Ferede et al., 2014). In particular, very recently, these countries have mainly emphasized the promotion of MSEs as a means to improve the well-being of local, national and regional communities (Gebreyesus, 2007). Empirical evidence also suggests the contribution of MSEs in generating employment and income has become increasingly recognized around the world (Liendholm, 2001). From an economic perspective, micro and small-enterprises represent a growing source of productive employment, especially for the lowest income groups, because these firms are more labor intensive than large industry, and require fewer technical skills (Robert and Maria, 1985). For instance, according Bereket (2010), the income contribution of the micro and small enterprise sector in Tanzania was about 20-30 percent of the GDP, and they consist of more than 1 million enterprises engaging 3 to 4 million persons, that are about 20-30 percent of the labor force of the country. In most African countries, micro and small enterprises (MSE) account for a significant share of production and employment and are therefore directly influencing poverty alleviation (Agyapong, 2010). Micro and small enterprises (MSEs) are considered as a spring board for broad based growth and enhance competition and entrepreneurship, and

hence have external benefits in terms of economy-wide efficiency, innovation and aggregate productivity growth.

In addition, MSEs boost/enhance employment more than large firms as MSEs are more labor-intensive (Ayyagari et al., 2005). Furthermore, in many African countries MSE employment is nearly twice the level of total employment in registered large-scale enterprises and the public sector, confirming that micro and small enterprises are a major source of livelihood for a significant proportion of the population in these areas (Liedholm, 2001). Therefore, MSEs are considered to be critical in kick-starting broad-based growth and enhance employment creation, especially in developing countries that aspire to have sustainable economic growth.

Cognizant of this, the Ethiopian government issued the National Micro and Small Enterprises (MSE) strategy in 1997 and established the Federal Micro and Small Enterprises Development Agency (FMSEA) to harness the benefit of such strategy. Consequently, the government has emphasized the role of MSEs and provided support to this sector. Accordingly, the share of formal employment increased in urban areas, while informal employment declined from 4.3 percent in 2005 to 3.2 percent in 2013, declined by 1.1 percentage points. In 2005, of the 4.0 million employed people living in urban areas, 1.32 million were employed in the informal sector, and the same figure increased to 1.33 million in 2013. This implies that while there are still a large number of workforces employed in the urban informal sector, it has not grown significantly since 2005 (Ferede et al., 2014). This evidence/figure confirms that although a focus on broad-based growth and transformation through the promotion of MSEs has been underscored in various development plans, both the level of unemployment and quality of jobs remains a concern in Ethiopia. MSEs have been performing below capacity and their growth has been severely constrained by a number of factors (Gebreyesus, 2007). Thus, job creation or employment opportunities to alleviate the widespread poverty and create an internationally competitive industrial structure are among the policy challenges the Ethiopian government is currently confronting. Faced with these challenges, the government has realized that enabling strong employment growth is an essential part of the strategy to achieve inclusive growth through MSEs expansion.

In order to make the MSE sector the engine of economic growth and reduce the problem of unemployment, it is important to understand what factors determine growth and investment in innovation in MSEs in the context of Ethiopia. In this paper, it provides microeconomic evidence on the determinants of firm performance in Ethiopia, with a focus on MSEs.

This paper was written with the scope of identifying the Determinants of growth of micro and small enterprise: Empirical evidence of Ethiopia, a review paper. So, the objective of this reviews is:

- *To review related literature of the Determinants of growth of micro and small enterprise*
- *Identify the gap based on the review of the literatures*
- *Concluding and recommending based on the reviewed papers.*

## 2. Methodology

This review was based on common search engines/databases (Google scholar and Science direct) and keywords such as “the determinants of MSEs”, “the achievements of MSEs” and, factors affecting MSEs growth”. The study reviewed 8 relevant articles on micro and small enterprises. Moreover, pertinent MSEs policy documents from the Federal Micro and Small Enterprises (FMSEs) website, proclamation as well as other research documents relating to MSEs in Ethiopia were reviewed and analyzed. These efforts provided us the information necessary to arrive at some conclusion on the subject matter in Ethiopia.

## 3. Literature Review

### 2.1 Definitions of micro and small enterprises

Although many countries around the globe seem to use common factors in their definitions, the degree of emphasis and measures used differ quite considerably. These factors include number of employees, volume of sales, and the capital value of the business. Generally, there are two types of definitions. The first is operational definition, which are largely used for working purposes and the other is theoretical definition, which are generally, employed to characterize the sector (Zemenuand Mohammed2014).

A definition of MSEs in the developed world would differ from how MSEs are defined in the third world. An enterprise categorized as microenterprise in USA may be treated as medium enterprise in Africa for the fact that the definition of MSE is relative to economic development. The Ethiopian government defines MSEs based on the size of the capital and level of automation (AbdulnasirAbdulmelike., 2018, p. 70)Accordingly micro enterprises are those small business enterprises with a paid-up capital of not exceeding Birr 20,000 and excluding high-tech consultancy firms and other high-tech establishments and Small enterprises are those business enterprises with a paid-up capital of above Birr 20,000 and not exceeding Birr 50,000.

In the improved definition of MSEs of Ethiopia (MSE strategy, 2011), Ethiopian Ministry of Trade and Industry and Central Statistical Authority (CSA) define MSEs according to the number of employees and capital. Ministry of Trade and Industry adopted official definition of Micro and Small enterprise in Ethiopia is as follows.

**Table1:** Definition of MSEs according to Ethiopian Trade and Industry Office

Enterprise	Sector	Employee	Capital
Micro-enterprise	Industry	<=5	<= ETB 100,000.00
	Service	<=5	<= ETB 50,000.00
Small-enterprise	Industry	6-30	<= ETB 1.5million
	Service	6-30	<= ETB 500,000.00

Source: Ethiopian Trade and Industry Office (2011)

The theoretical basis for this study is the augmented form of the learning model which includes a measure the business environment and characteristics of the firm. The learning model of Jovanovich (1982) posits that there is an inverse relationship between the growth of MSEs and the characteristics, age and size of the enterprises.

According to “learning models” a firm “learns” about its productivity over time-efficient firms invest and expand while less productive ones stay small, shrink or exit. These classes of models also predict that firm age and size are both negatively correlated with firm growth: as firms grow older or become larger, their rate of growth slows (Stella et al, 2014).

Testing a growth model of firms using firm level data from Ghana, Teal (1999) finds that the rate of job creation in Ghana's manufacturing sector is highest in medium-sized firms and those small firms do not grow more rapidly than larger firms.

On the link between MSEs success (or growth) and innovation, the literature also indicates that innovation activities are seen as driving forces for business success and economic development. Owing to this, innovation has frequently been credited for improving organizational competitiveness and success in a dynamic market environment (Chen, 1994; Enos, 1989; tire, 1997; Bozic and Radas, 2005; Handoko et al., 2014). Innovation is the “implementation of a new or significantly improved product (good or service), a new process, a new marketing method, or a new organizational method in business practices, workplace organization or external relations” (OECD/EC, 2005). In this study they adopt an innovation defined as the implementation of a new or significantly improved product and /or a new process. Innovation by firms is associated with better access to finance by firms.

### 2.2 Factors Affecting Growth of MSEs in Ethiopia

Although several challenges inhibit the growth of MSEs, the critical problem is damaging rent-seeking behaviors, which are manifested in different forms. Other challenges that undermine the growth of MSEs are access to technology, skills, capital financing and markets”. (AbdulnasirAbdumelike., 2018)

The NBE restricts commercial banks to go beyond 25% of their capital for single borrower and 15% of their total capital for a related party. Similarly, the NBE directive no. MFI/18/06 limits MFIs not to go beyond 1% of their capital for individuals who can provide collateral and not more than 4% of their capital for group collateral. These lending restrictions were imposed on private banks and then replaced by an NBE directive (MFA/NBE Bills/001/2011) which obliges commercial banks to allocate 27% of total loan disbursed during the month for the purchase of low interest bearing NBE bills. The NBE bill purchase requirement continues to severely constrain private commercial bank operations which in turn results in favoring existing, established clients when allocating loans as opposed to newer, riskier SMEs (GemechuAbdissa., 2016, p. 72).

Despite the presence of strategies that aim to support MSEs, the enterprises are weakly performing. Supporting this, ECA (2001) concluded that countries such as Cameron, Ethiopia, Gabon, Nigeria, Senegal and Uganda have shown that the policy environment in which MSEs operate proves to be a major handicap for their expansion and growth. Besides, the complexity of the customs system and the many forms and declarations required have had a negative impact on the general business climate, diverting entrepreneurs' efforts from more productive tasks.

### 3. Empirical Review

Hence, several empirical evidences exist to explore what factors determine the growth of MSEs, if any, in terms of employment. A firm's ability to grow and strengthen its competitive depends highly on its potential to invest in new ventures, innovation, improvements and diversification over time (ITC SME Competitiveness, 2015). While small firms mainly employ or engage the poor, the growing firms can help them out of poverty with higher, more stable wages (ANDE, 2012). For instance, Gebreyesus (2007) conducted a study using a learning model of firm growth to investigate some key determinants of success, particularly employment expansion among micro-enterprises in six major towns in Ethiopia. The findings indicate that firm's initial size and age are inversely related to growth, providing evidence that smaller and

younger firms grow faster and larger than older firms and the finding is consistent with the learning hypothesis. A study by Haile et al. (2014) revealed that access to credit from formal financial sources, access to infrastructures and access to working premises are significant factors affecting the growth of MSEs. Besides, a study conducted by Tefera et al (2013) on growth determinants of MSEs in Mekele city indicates that the sex of the manager, initial investment in the firm, location of, and the sector in which firms operate determine the growth of MSEs.

A study of firm innovation in over 19,000 firms across 47 developing economies (Ayyagari, Demirgüç-Kunt, and Maksimovic, 2011) found that external finance was associated with greater innovation by all private firms. Innovative firms tend to experience higher levels of productivity and economic growth (Cainelli, Evangelista and Savona, 2004). They are more likely to export, and export successfully (Love and Roper, 2013). It does so by stimulating innovation in products, processes, management, routines and marketing strategies.

Using data on Indian manufacturing firms, Bas and Paunov (2014) analyzed the heterogeneous impacts of inward liberalization policies (e.g., dismantling of 'License Raj') on firms' decisions to invest in research and development (R&D). The results show that the probability of undertaking investment in R&D increased by about 92 percent compared with firms operating under production licenses. The result also indicated that smallest and least efficient firms were less likely to do invest in R&D even under a liberalized production system.

#### 4. The Gap Identified

Based on the review of the literature on the study area indicated that there is *information gap* on the contribution of MSEs Sector all over the economy of the country. The review of the literature reveals the existence of many *gaps of knowledge* in respect of the factors affecting MSE performance, particularly in the context of Ethiopia. As per the review of the literature most of the empirical studies that have been conducted with the aim of identifying determinants of growth of MSE belong to Ethiopia did not follow the appropriate econometric analysis (*methodology gaps*).

In the context of Ethiopia, a few related studies were conducted Addis Ababa. Accordingly, the findings of study may not necessarily apply to other MSEs operating in other parts of the country; therefore, the results may not be generalized to Ethiopia. The study fails to fill the knowledge gap that exists in the Ethiopia i.e., did not identify dependent and independent variables; and considers to the extent that only very few external variables and overlooked internal variables that may significantly affect MSE growth of capital. In addition, the sample is very small representation of the entire MSEs business sector in certain cities.

In general, the lack of sufficient research on the determinants, growth, performance, contribution and constraints of MSEs results such gaps.

### 5. Conclusions, Recommendations and Implications

#### 5.1 Conclusions

It can be concluded from the above literature that the key factors for the growth of micro and small enterprises include characteristics of MSEs and managers, institution, location, the sectors in which the MSEs operate and innovation or competitiveness. It is worth nothing that the correlation between the growth of the firm and its size is inconclusive for the fact that some argue that smaller firms don't grow more than the larger ones, on the one hand, and others argue that the growth and size of MSEs is inversely related. But, most of the empirical studies from African countries, including Ethiopia, are consistent with the latter finding that the growth of MSEs is inversely related to their size. Broad-based growth and transformation, through the promotion of MSEs, has been underscored in various development plans in Ethiopia, but both the levels of unemployment and quality of jobs remain a concern in Ethiopia. Thus, increasing employment opportunities to alleviate the widespread poverty and create an internationally competitive industrial structure are among the policy challenges the Ethiopian government is currently confronting. In order to make the MSEs sector the engine of economic growth and reduce the problem of unemployment, it is important to understand factors influencing the growth of MSEs in the context of Ethiopia. We provide empirical evidence on the anatomy of MSEs based on a sample 300 micro and small enterprises in Addis Ababa. We use both descriptive and econometric methods to analyze the data. In particular, the econometric model is based on an augmented form of learning models of firms.

The result shows that MSEs have limited linkages with other firms, and is less integrated with the external market, suggesting MSEs, especially small enterprises has not benefited from linkages with larger firms. In addition, limited integration with the external market means that MSEs, especially small scale enterprises have not benefited from technology transfers and other useful business related exposures.

The result also indicates that access to finance appears to be a very severe or major obstacle as reported by about 55% and 64% of micro and small scale enterprises. The problem of access to finance is more severe for small enterprises compared with micro enterprise as the latter often have access to microfinance institutions (MFIs) as their loan requirement is within the capacity of MFIs. A large proportion of both micro and small



enterprises have not applied for a loan or credit due to cumbersome bureaucracy, limited working premises, and high collateral requirement.

The quantitative analysis also indicates that the characteristics of both top managers (owners) and firms do matter for the performance of MSEs. Among manager's or owner's characteristics, age, marital status and education were important factors affecting growth of both micro and small enterprises. Most importantly, human capital development targeting managers of MSEs can boost employment creation via the expansion of MSEs as reflected by the fact that an MSE manager having a secondary school education and technical and vocational education training is positively related with firms' growth. Besides, human capital development is also important for the workers of the enterprises as it was found that businesses with larger proportion of skilled production workers shows statistically significantly higher growth than those businesses with less trained workers.

The finding of this study also reveals that weak business environment influences the growth of firms. In particular, frequent power interruptions, lack of access to credit, and shortage of water is inversely correlated with the growth of MSEs. For small enterprises, access to credit appears to be the main problem as these firms are too big for non-bank financial institutions at the same time they are too small for commercial banks, reflecting the missing middle financial intermediation.

The major finding of this study is that start-up size and growth of the MSEs are negatively related, which means that MSEs that start business larger in size in terms of employment grows slower than their counterparts. This finding is consistent with the relatively recent learning model of firms; as firms grow older or become larger, their rate of growth slows because they are already at a higher level of productivity.

Innovation activities are seen as driving forces for business success and enhance competitiveness as it has often been credited for improving organizational productivity. But the finding from this study indicates that innovation is taking place only in a small proportion of MSEs in the study area. The findings suggest that policies to improve the share of MSEs where innovation takes place need to be in place to enable MSEs play the role of acting as engines of economic growth by creating more jobs thereby improve the conditions of the unemployed people in the country. Furthermore, developing the human capital of the MSEs through providing training, encouraging experience sharing, improving access to internet and taking account of sector dependent nature of innovation are very important should the policy of development through expansion of MSE be successful.

### **5.2 Recommendations**

The findings of the study call for appropriate supportive interventions to improve the performance of micro and small enterprises in Ethiopia. Hence, the primary focus should be to enhance the growth and productivity of MSEs through targeted support aimed at generating employment opportunities for the rapidly growing work force, especially in urban areas of Ethiopia. Specific interventions shall focus on the following.

- There is a need for developing continuous capacity building program to enhance the capability of MSEs, especially human capital through anchoring with relevant training institutions that cater the needs of MSEs.
- It is recommended to improve access to finance, especially small enterprises. This requires establishing a special window at commercial banks or improving the capacity of MFIs to enable them avail adequate loan to small enterprises.
- There is a need for improving key infrastructure such as power supply distribution and access to water.
- It is recommended to enhance the integration and linkage of micro and small enterprises with medium and large enterprises through training, experience sharing and access to improved technologies. Networking and sub-contracting with other firms is a key to develop technology capability.

### **5.3 Policy Implication**

Recent empirical studies show that MSEs contribute to over 60% of GDP and over 70% of total employment in low-income countries, while they contribute over 95% of total employment and about 70% of GDP in middle-income countries. Therefore, an important policy priority in developing countries is to reform the policies that divide the informal and formal sectors, so as to enable the poor to participate in markets and to engage in higher value-added business activities. Policies to promote the development of MSEs are common in both developed and developing countries. In the case of developed countries, it has become common place for governments during the last two or three decades to implement policies or programs designed to promote aspects of micro and small-sized enterprises (MSEs). (GemechuAbdissa., 2016, p. 47)

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