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Sources of Entrepreneurial Finance in Dodoma Municipal, Tanzania

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Abstract

Small businesses irrefutably remain critical to the development of any country's economy as they are an exceptional, source of workgroup, help in expansion of local know-how, and develop originalfinanciers. A crucial component in the growth of the SME sector is access to finance, particularly to bank financing, given the relative importance of the banking sector in serving this segment. Since failure of people of Tanzania to get seed capital severely affects the community livelihood and that SMEs have been proved to alleviate poverty. The main purpose of the study is to evaluate the entrepreneurial finance challenges and the extent of financing of SMEs within the Dodoma Municipal, taking cognizance of the role and contributions of Financial Institutions in Tanzania. The study purposively sampled 100 respondents out of which 80 respondents were drawn from 80 SMEs and 20 respondents from lecturers belonging to [5] high learning institutions and [15] funding institutions respectively. The study further revealed that high interest rates; lack of finances and unfavorable tax charges as major constraints to the growth of SMEs. The major challenge could be interpreted to mean lack of entrepreneurial finance.

Key Words: SMEs capital, Entrepreneurial Finance, SMEs projects.

Introduction

The financial structure is the vessel that transmits this life-blood over the economic system. Faulty vessels prevent the life-blood from reaching essential parts of the economic system" (Sowah N.K., 2003). Small industriesconclusively remain dangerous to the growth of any nation's budget as they are an outstanding, source of employment generation, help in development of local technology, and develop indigenous entrepreneurs (Erdem and Erdem, 2011; Alaye-Ogan, 2012). The importance of small businesses to the citizens' standard of living and the nation's general growth cannot be overemphasized.

Start-up (Seed Capital) SMEs are a key driver of sustainable economic development of the country. Start-ups for the purpose of this research are defined as new businesses that have been in operation for a period of less than 3.5 years (Maas & Herrington, 2006). In addition, Maas and Herrington (2006) suggest that if the government wants to sustain economic growth that will create wealth for all, efforts should be made to increase new business start-ups.

According to the Umsobomvu Youth Fund (2008) only about two out of every ten applications for credit by start-up SMEs are approved in Africa. Wood and Herrington (2005) also point out that 75% of credit applications by start-up SMEs to banks in Africa are rejected. In developed countries, the situation is markedly different. According to Statistics Canada (2004) in Riding and Orser (2007), there is approximately 82% approval rate for credit applications by start-up SMEs in Canada. In 2000, 23% of start-up SMEs made requests for debt financing and 82% were approved. Of the loans approved, 75%were not covered by a federal loan guarantee. In England, 71% of applications for credit by start-up SMEs from financial institutions between 2004 and 2007 were approved. Twenty six percent (26%) were wholly or partially rejected. A ninety three percent (93%) success rate was achieved in asset based lending and factoring, 75% for overdrafts, a 70% success rate for credit cards and 88% for leasing and hire purchase. This suggests a weak access to finance by start-up(seed capital) SMEs in Africa which must be addressed if their high failure rate is to be reduced. In developing countries, this task is executed by Microfinance Institutions (MFIs), which provide small loans, to financially excluded people who cannot offer any collateral (Kirumba, 2000).

Tanzania SME National Policy also indicates that SMEs all over the world are known to play a major role in social economy development. This is apparently the case of Tanzania, where SMEs contribute significantly to employment creation, income generation and stimulation of growth in both urban and rural areas. It is estimated that about one third of the GDP originates from the SME sector.

Brush and Hart, (2001), sadly noted that there hasn't been any bank or funding agencies with deliberate policy model of encouraging and promoting entrepreneurial finance and resource acquisition. In the same vein, Chigunta, (2001) submitted that if such institutions, are there, their interventions are yet to be registered in the society most probably because budding entrepreneurs have not been able to cope up and stomach their stringent requirements for would be beneficiaries of such funding agencies and financial institutions.

Since failure of people of Tanzania to get seed capital severely affects the community livelihood and that SMEs have been proved to alleviate poverty, therefore there is a growing need of assessing factors affecting the acquisition of seed capital among entrepreneurs in Tanzania.

Literature Review

An overview of Small Business Financing Theory

In a seminal paper, Ang (1992) demonstrated the importance of acquiring start-up capital for small businesses. While finance theory generally posits that all firms have equal access to financial markets and that all share similar competitive positions (van Auken and Neeley, 1996), small businesses often face severe difficulties compared to large businesses. Numerous supply-side factors - limited information, market imperfections, and agency relationships to name only a few - affect small firms particularly severely and make traditional finance theory inapplicable to their situation (Ang, 1992; McMahon et al., 1993; Petty and Bygrave, 1993). Indeed, sources of finance available to small businesses differ strongly from those available to large companies, and their widespread lack of access to the loan market violates the assumptions of perfect capital markets (Ang, 1992, van Auken and Neeley, 1996).

Pecking Order Theory

Ang, (1992) rightly observed that financing decisions for new ventures may also be more complex because they are closely linked to the personal wealth or contacts of the owner/manager. Accordingly, agency problems may be more intense as shareholders and partners are often made up of family and friends. Consequently, the pecking order theory of firm financing is one method firms might use to address these agency problems. Both Myers, (1984) and Myers and Majluf, (1984) submitted that this theory holds that new ventures do not intend for a target debt ratio. As an alternative, new ventures opt for funding sources that minimize the cost of capital. In the case of the startup businesses or new venture, personal sources are used first, external debt next, followed by outside equity.

In survey of 136 small firms in Tanzania, Satta (2003) found that 63% of them consider difficulties in accessing finance from financial institutions as the major constraint to their development. Ayyagari et al., (2006) using sample of 80 countries including Tanzania they found that access to finance is an important constraint to firm growth. They suggest for further investigation of country and firm level determinant of financing obstacles for future work. Maliyamkono (2006) noted that total credit during 2006 stood at 36% of commercial banks deposits and was concentrated on large firms. Likewise, Olomi (2009) noted that, studies consistently show that over 70% of SMEs in Tanzania perceive finance to be the most serious impediment to the establishment and development, although banks in Tanzania generally do not have liquidity problems.

Cogburn and Adeya, (2000) posits that the information and communication infrastructure in most African nations is feeble yet access to information infrastructure is considered an indispensable condition for widespread socio-economic development in this age of globalization and information economy. According to Eifert and Ramachandran, (2004) the result of poor communication networks in most African countries is the low level of Internet usage. On the other hand, Africa has low telephone penetration; insufficient broadcasting facilities; computing infrastructure and other consumer electronics.

Ramachandran, (2004) submitted power supply as a leading challenge in most African nations. In response to power cuts and shortages, few entrepreneurs who can manage to pay for generators to power their business operations (Akwani, 2007). However, the use of generators increases production costs and making their products less competitive. Additionally, poor transportation facilities and bad roads result in higher cost of moving goods from one area of the country to the other.

Research Methodology

This research study is aiming to provide vision with regard seed capital challenges for small and medium enterprises (SMEs) in Dodoma Municipal.

A research design focuses on a conceptualized, practical structure within which a study is conducted and constitutes a blue print for measuring variables, collecting and analyzing data.

The method of convenience sampling was employed in arriving at the 80 SMEs, which the researchers believe possesses the experience relevant for this study and who have sufficient time and were willing to participate (Morse, 1998).

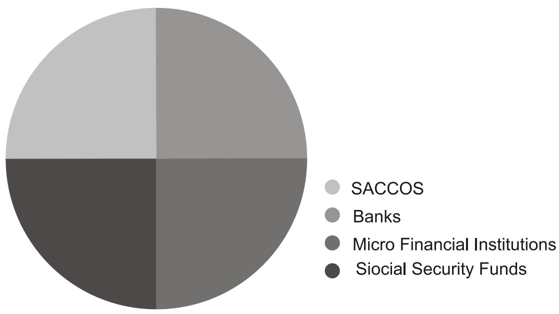
The researcher has used personal in-depth interviews to optimize data collections from the SME experts and funding institutions to understand their opinions and experiences in relation to seed capital challenges for small and medium enterprises (SMEs).

The study employed both probabilistic and non-probabilistic sampling procedures. The data and sample size of this research has been determined based on Sekaran (2010, p, 295) sample determination table. Data are analyzed and summarized by using both SPSS and excel and the appropriate recommendation and conclusion were drawn. Data are analyzed using both qualitative and quantitative techniques. Secondary data are analyzed using documents reviews and available literature.

Findings and Discussion

In the face of the increasing recognition of SMEs as a source of job creation, empowerment and economic vitality in a rapidly globalizing world, it is imperative to undertake an investigation on available sources of entrepreneurial finance and their requirements, thus the prerequisites for funding granted to SMEs. This has been motivated by the fact that the potential benefits of SMEs as a viable career option so as to later discover obstacles or rather challenges they may face in their [SMEs] entrepreneurial finance and resource acquisition journey. Figure 1 below highlights the potential sources of funding for SMEs

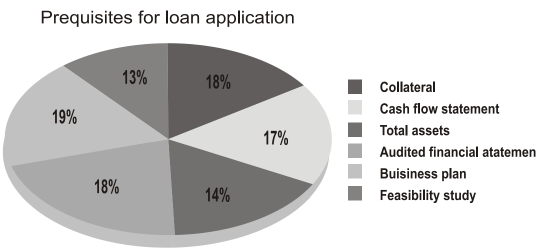
Figure 1: Potential Sources of Funding for SMEs in Dodoma



Source: Author Field Findings (2016)

The figure above shows that 25% SMEs receive funding from banks; 25% receives their funding from micro financial institutions; 25% get their funding from social security funds; while 25% receive their funding from SACCOS. This is in agreement with Brush, and Hart, (2001) rightly observed that businesses often need more capital than owners are able to provide. Consequently, they source financing from external investors which include: angel investment, venture capital. In addition, though with fewer incidences, they also source from crowd funding, hedge funds and alternative asset management (Alemany, 2007). According to Mason, (2009) sources of funding include but not limited to: Banks; Government; NGOs; Microfinance institutions; Donor Agencies; Business Angels; Family. However, these are usually described and categorized in technical terms namely the business angels and the venture capital. Alternatively, they can be categorized as external financing and business Angels respectively. Having have realized the sources of funding in Dodoma the next step was to discover the prerequisites for loan application.

Figure 2: Discovering prerequisites for loan application

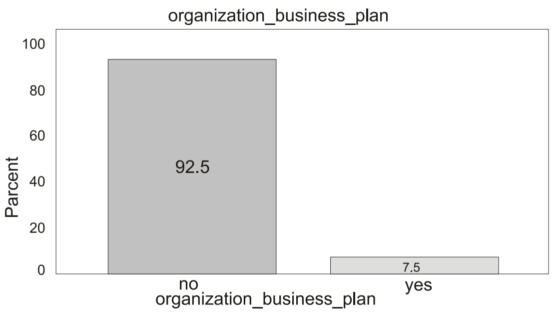


Source: Author Field Findings (2016)

The above pie chart highlights the views of SMEs regarding the Prerequisites for loan application to which respondents rated Business plan to be the top requirement [19%]; followed by Collateral [18%] which tied with Audited financial statement [18%] followed by Cash flow statement [17%]; followed by Total Assets [14%] and feasibility study [13%] which was rated the least. This implies that in as much as business plan; collateral security and audited financial statements are top requirements, the rest of the prerequisites are also some of the extra requirements demanded by banks and other funding institutions for SMEs to produce when applying for loans. This is indicative of the fact that seed capital is hard to come by for many SMEs as they would not be able to meet bank requirements.

The next set of question was determined to find out if the SMEs under study had an existing business plan and the majority of respondents revealed that they don't have business plan as enshrined [on the graph] figure 3.below.

Figure 3: Exploring the number of SMEs who have business plans



Source: Author Field Findings (2016)

The figure above highlights that the majority of SMEs don't have the business plan as suggested by 92.5% of the respondents compared to only 7.5% who said they have business plans. The conclusion is that many SMEs don't have business plans. The implication is that they do the business without the book and have no road map on which their business has to follow. In other words, they just operate anyhow. It also implies and justify why financial acquisition for these SMEs could be difficult because the banks and other financial institutions would set that (business plan) as a requirement in sourcing funds from them.

Conclusion

The study further revealed that high interest rates; lack of finances and unfavorable tax charges as major constraints to the growth of SMEs. In a nutshell, the major challenge could be interpreted to mean lack of seed capital. In the event funding institutions become flexible in their requirements for loan applications, respondents registered their willing to increase the number of their employees; the number of branches and willingness to accept professional advice. In other ways, the only best way to help SMEs access seed capital lies in the hands of funding institutions as justified and suggested by the majority of SMEs who submitted that the key determinants for seed capital acquisition are: fair and low interest rates; philanthropy; in-excessive demand for collateral security; less cumbersome procedures and realistic repayment schedules. It is to this effect that the study conclusively posits with a heavy heart that most probably there hasn't been any bank or funding agencies with deliberate policy model of encouraging and promoting SMEs activity in Tanzania and Dodoma in particular. If such institutions, are there, they could be very few with less impact and their robust interventions are yet to be registered in the society most probably because SMEs have not been able to cope up and stomach their stringent requirements for would be beneficiaries of such funding agencies and financial institutions.

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