

**INFLUENCE OF FINANCIAL INSTITUTIONS IN THE DEVELOPMENT OF
SMALL AND MEDIUM ENTERPRISES (SMEs) IN TANZANIA:**

THE CASE STUDY OF MOROGORO MUNICIPAL COUNCIL

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SMALL AND MEDIUM ENTERPRISES (SMEs) IN TANZANIA:
THE CASE STUDY OF MOROGORO MUNICIPAL COUNCIL**

**BY
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**A Research Dissertation Submitted in Partial Fulfilment of the Requirements for
Award of the Master Degree MBA Corporate Management of
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CERTIFICATION

The undersigned certifies that he has read and hereby recommends for acceptance by the University of Mzumbe a Dissertation entitled: **Influence of Financial Institutions in the Development of Small and Medium Enterprises (SMEs) in Tanzania** in partial fulfilment of the requirements for the degree of MBA (corporate management).

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DECLARATION

I, **Jane Alexander Mlise**, declare that this dissertation is my own original work and has not been presented and will not be presented to any other University for a similar or any other degree award.

Signature.....

ACKNOWLEDGEMENT

The completion of this dissertation has been a result of combined efforts of several individuals who assisted me in one way or another to bring this study to its present form. It is hard to mention them all by names, but to them all, I remain so indebted. However, I wish to express my sincere thanks, first of all, to my supervisor, Dr. Jaraj Kikula, who deserves a special mention and heartfelt gratitude for his supervision, valuable criticisms and constant encouragement he offered me during the preparation of this work. Without his devotion and commitment, the completion of this work would be a nightmare.

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I wish to associate all those persons mentioned above with the positive aspects of this work, but relieve all from any responsibility concerning any shortcomings, both in form and content.

DEDICATION

This work is dedicated to my parents and my husband, Mr. Paul Abdiel, who always give me courage and support, the outcome of which is this work.

ABSTRACT

This research report presents the findings of the study done in Morogoro Municipality, “influence of financial institutions to the development of SME’s.” Specifically, the research was undertaken to determine the existing financial institutions financing SMEs in Morogoro Municipality, determining the extent to which financial institutions have helped to finance SMEs in Morogoro Municipality as well as to determine constrains facing SMEs towards financial institution support.

The study draws on primary and secondary data. In primary data collection, interviews were conducted with SME’s owners whereby women, men, MFI’s officers of Morogoro municipality were purposely involved. Personal observations were also used to collect some of the data. Secondary data were collected from the government offices, MFI’s and other literatures.

By using the sample of 60 respondents in Morogoro SME’s owners, field survey shows that small and medium enterprises (SMEs) are constrained by financing and other institutional obstacles than large enterprises, exacerbated by the weaknesses in the financial systems of many developing countries. We use the concept of the access possibilities frontier to explain how difficulties in managing risk and transaction costs involved in SME lending make financial institutions and markets so reluctant to reach out to this group of enterprises, especially in developing countries.

We discuss different policies and reforms that can entice financial institutions and markets to lend to SMEs and comment on the role of the Government in institution building, providing the regulatory framework and undertake market-friendly activist policies. However, we also point to pitfalls in government's involvement in SME financing and suggest that restricted conditions in obtaining financial support should be reviewed.

LIST OF ABBREVIATIONS AND ACRONYMS

CBO's	Community Based Organisations
SME's	Small and Medium Enterprises
GDP	Growth Domestic Product
MDG	Millennium Development Goal
MIT	Ministry of Industry and Trade
MFI's	Microfinance Institutions
MSME's	Micro, Small and Medium Enterprises
NGO's	Non Governmental Organisations
NSGRP	National Strategy for Growth and Reduction of Poverty II
TDV	Tanzania Development Vision
UN	United Nations
URT	United Republic of Tanzania
WB	World Bank
FIs	Financial Institutions

DEFINITION OF KEY TERMS

Financial institution

It is an institution that provides financial services for its client or members particularly, it acts as a financial intermediary that accepts deposits and offers loans.

Development

It refers to the process which enables human beings to realize their potential, build self-confidence and lead lives of dignity and fulfillment.

Small and Medium Enterprise (SME's)

It refers to Small enterprises with mostly formalized undertakings engaging between 4 and 5 employees or with capital investment from Tshs.5 million to Tshs.50 million and Medium enterprises employ between 5 and 50 people or use capital in investment from Tshs.50 million to Tshs.100 million.

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CHAPTER ONE

INTRODUCTION

1.1 Background Information

The role of Small and Medium Enterprises (SME's) in the development process continues to be in the forefront of policy debates not only in developing countries but also in developed countries. International Labour Conference adopted a recommendation which recognizes the importance of a policy and legal framework in setting an environment for small enterprises development (ILO, 1998). The advantages claimed for SME were various, including the encouragement of entrepreneurship, the greater impact on employment generation, they can usually be established rapidly and put into operation to produce quick returns and they may well become a countervailing force against the economic power of larger enterprises.

In most African countries as in other parts of the world, small enterprises development was increasingly seen as a crucial ingredient towards poverty alleviation and creation of employment. SMEs account for up to 90% of employment in the industrial sector and 60% to 70% of domestic industrial production. Their contribution to export earnings varied from 75% to 80%. It was estimated that, only 5% to 10% of all developing countries engage in export related activities. There was a vast export potential in currently-not-exporting SMEs waiting to find expression (ITC, 1997b).

In Tanzania, majority of population were making their living on agriculture and Small and Medium Enterprise activities. According to statistics from United Republic of Tanzania and Ministry of Industry and Trade the state of SMEs in Tanzania has continued to deteriorate despite the government efforts of initiating and enabling environment for their survival such as setting up funding kitty to act as guarantor in order to secure loans from financial institutions (URT, 2002). Also, other institutions like government, NGOs, and CBOs are ill equipped in terms of

equipment, personnel and operational funds, and therefore, unable to discharge their mandated responsibilities (MIT, 2003).

In addition, development of SMEs facilitates distribution of economic activities within the economy and thus fosters equitable income distribution. Furthermore, SMEs technologies are easier to acquire, transfer and adopt. Also, SMEs are better positioned to satisfy limited demands brought about by small and localized markets due to their lower overheads and fixed costs. Moreover, SME owners tend to show greater resilience in the face of recessions (URT, 2002). Through business linkages, partnerships and subcontracting relationships, SMEs have great potential to complement large industries' requirements. A strong and productive industrial structure can only be achieved where SMEs and large enterprises not only coexist but also function in a symbiotic relationship. This research study looked at the role played by Microfinance Institutions in promoting enterprise culture among SMEs by focusing on CRDB Microfinance Ltd as a case study (World Bank, 2003).

The SME sector in Tanzania is faced by many challenges such as limited access to finance and lack of enterprise culture. To address these challenges, that is where Microfinance Institutions (MFIs) come in. MFIs are the primary source of finance to SMEs and are also contributing towards promotion of the enterprise culture by offering various forms of training to SMEs. MFIs that help to promote the enterprise culture in Tanzania include Akiba Commercial Bank (ACB), Tanzania Postal Bank (TPB), National Micro Finance Bank (NMB) and CRDB Microfinance (Satta, 2002)

1.2 Problem Statement

There has been improved access to credit by SMEs overtime. However, SMEs have continued to suffer financial challenges. For this, existing research indicates that 53.7% of the SMEs operate in a financial deficit and some of the SME owners are still uncomfortable with such credit extended to them, (Sendawula 2002). The SMEs have registered a low return on capital employed, low net profit margin and kept a

small capital size (AMFIU 2010) and some of them fail to run their daily operations because they do not have the capacity to maintain adequate liquidity levels Chowdhury (2002). As such, the relationship between the Financial Institutions and SME keeps on deteriorating due to failure to fulfill their loan obligations O'brien (2007). This could be due to the stringent credit terms to include interest rates, collateral securities, and loan repayment schedules among others which seem to frustrate businesses financially.

In Morogoro Municipality, there is little empirical data on credit terms and how they affect the SME performance. However, the ability of SME to grow depends highly on their potential to invest in restructuring, innovation and qualification (URT, 2004). All of these investments need capital and therefore access to finance. Thus, this study was intended to determine the influence of financial institutions in development of Small and Medium Enterprises (SME's) in Morogoro Municipality.

1.3 Significance of the Study

On recognition of the fact that many indigenous SMEs in Tanzania do not have ability to acquire financial capital, the government has given out a total of 4.85billion in loans to 14,272 SMEs for the financial year ending 2003/2004 as a support to Small and Medium scale entrepreneurs` development projects (URT, 2004). The research findings would be useful to many stakeholders including SME's owners, researchers, Ministry of Industry and trade, Business Environment Strengthening for Tanzania Agent, planners and policy makers. It would be useful in guiding the monitoring and evaluation of the impacts of financial institution's support towards SMEs development. It would be also helpful in mobilizing District, Regional, National, and International Resources for the SME's development programme.

1.4 Objectives of the Study

1.4.1 General Objective

The aim of this study was to determine the influence of financial institution's in development of Small and Medium Enterprises in Morogoro Municipality.

1.4.2 Specific Objectives

- (i) To establish whether Financial Institutions provide favourable credit terms to SMEs in Morogoro Municipality.
- (ii) To establish the relationship between financial institution credit terms, and SME development.
- (iii) To determine the extent to which financial institutions have helped to finance SMEs in Morogoro Municipality.
- (iv) To determine constraints facing SMEs towards accessing financial institutions' support

1.5 Research Questions

- (i) Are the credit terms used by financial institutions while lending to SMEs in Morogoro Municipality favourable?
- (ii) What is the relationship between financial institutions credit terms, liquidity levels and SME development?
- (iii) To what extent had financial institutions helped to finance small and medium enterprises in Morogoro municipality?
- (iv) What were constraints facing SMEs towards accessing financial institutions' support?

1.6 Scope of the Study

The proposed research topic would concentrate on how financial institutions influence the development of the selected indigenous African Micro and Small sized Enterprises in business sector in Morogoro Municipality. The study covered mainly the owners of SMEs and their staff and Financial Institutions.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter presents a review of literature used by the researcher during the study. The chapter also includes conceptual definitions, empirical analysis and conceptual framework of the study. Microfinance is a relatively new concept that has grown exponentially in the last decade as investors, donors, and banks realize the potential for capital that can be made by banking to the poor. In the past it was assumed that poor people were unbankable since they were only capable of taking out small loans, and had no collateral (Brandsma and Chaouli, 1998). Grameen Bank in Bangladesh, the first to start banking to the poor, proved that not only are the poor bankable, but microfinance in the informal sector can be quite profitable. Since then microfinance institutions have sprung up all over the world and reached millions of poor people (Simanowitz and Walter 2002).

In essence, a microfinance institution (MFI) acts as a bank for the poor. In some cases, an MFI actually is a bank, or can become one, but usually it is an NGO or governmental programme aimed at poverty alleviation. The purpose of microfinance is to provide financial loans to the poor that are not made available to them through the traditional banking system. These loans can be as tiny as \$50, and are typically used by the client to start a small business (Brandsma and Chaouli, 1998). Because microfinance institutions operate primarily (though not exclusively) in the Third World, they are faced with unique difficulties; namely, lack of collateral and lack of infrastructure or mobility. Consequently, MFIs have adopted several innovative practices to accommodate for these difficulties. These practices are the use of village banks, trust and group lending and high interest rates (Brandsma and Chaouli, 1998). The availability of external finance for small and medium enterprises (SMEs) is a topic of significant research interest to academics and an issue of great importance to policy makers around the globe. The Conceptual framework to which most of the

current research literature adheres to has proven to be quite helpful in advancing understanding of the markets for providing funds to SMEs in both developed and developing nations. As well, this framework has aided understanding of the effects of policies that both facilitate and hinder the access to funding by creditworthy SMEs in Tanzanian nation.

However, researchers argue that the current framework presents an oversimplified model that overlooks some important distinctions across national financial institution structures and lending infrastructures and the way in which these elements of the financial system affect SME credit availability. By financial institution structure, that means the market presence of different types of financial institutions that provide credit, as well as the competition among these institutions.

By lending infrastructure, researchers mean the rules and conditions set up mostly by governments that affect financial institutions and their abilities to lend to different potential borrowers. They argue that differences in the financial institution structure and lending infrastructure may significantly affect the availability of funds to SMEs by affecting the feasibility with which financial institutions may employ the different lending technologies in which they have comparative advantages to provide funds to different types of SMEs.

2.2 Definition of Terms

2.2.1 Financial Institutions

A financial institution is an institution that provides financial services for its clients or members. Probably the most important financial service provided by financial institutions is acting as financial intermediaries. Most financial institutions are regulated by the government. There are three major types of financial institutions, namely Depository Institutions, Deposit taking institutions that accept and manage deposits and make loans, including banks, building societies, credit unions, trust companies, and mortgage loan companies, Contractual Institutions : Insurance

companies and pension funds; and Investment Institutes : Investment Banks, underwriters, firms. Financial institutions act as a development tool because they grant or provide financial services and products such as very small loans, savings, micro-leasing, micro-insurance and money transfer to assist the very or exceptionally poor in expanding or establishing their businesses. It is mostly used in developing economies where SMEs do not have access to other sources of financial assistance (Robinson, 1998). In addition to financial intermediation, some MFIs provide social intermediation services such as the formation of groups, development of self-confidence and the training of members in that group on financial literacy and management (Ledgerwood, 1999). There are different providers of microfinance (MF) services and some of them are: nongovernmental organisations (NGOs), savings and loans cooperatives, credit unions, government banks, commercial banks or non-bank financial institutions. The target group of MFIs are self-employed low income entrepreneurs who are: traders, seamstresses, street vendors, small farmers, hairdressers, rickshaw drivers, artisans blacksmith etc (Ledgerwood, 1999).

2.2.2 Development

Refers to the process which enables human beings to realize their potential, build self-confidence, and lead lives of dignity and fulfillment. It is a process which frees people from fear of want and exploitation. It is a movement away from political, economic, or social oppression. Through development, political independence acquires true significance. And it is a process of growth, a movement essentially springing from within the society that is developing. According to UNDP (1991), the basic objective of human development is to enlarge the range of people's choices to make development more democratic and participatory. It includes choices like decent wages and employment opportunities, education, healthcare, clean and safe environment, ability to participate in community decision making, and enjoyment of basic human, economic and political freedoms. The purpose or goal of any firm is to make profit and growth. A firm is defined as an administrative organisation whose

legal entity or framework may expand in time with the collection of both physical resources, tangible or resources that are human nature (Penrose, 1995). The term growth in this context can be defined as an increase in size or other objects that can be quantified or a process of changes or improvements (Penrose, 1995). The firm size is the result of firm growth over a period of time and it should be noted that firm growth is a process while firm size is a state (Penrose, 1995). The growth of a firm can be determined by supply of capital, labour and appropriate management and opportunities for investments that are profitable. The determining factor for a firm's growth is the availability of resources to the firm (Ghoshal, Halm and Moran, 2002

2.2.3 Small and Medium Enterprises

The SMEs nomenclature is used to mean micro, small and medium enterprises. It is sometimes referred to as micro, small and medium enterprises (MSMEs). The SMEs cover non-farm economic activities mainly manufacturing, mining, commerce and services. There is no universally accepted definition of SME. Different countries use various measures of size depending on their level of development. The commonly used yardsticks are total number of employees, total investment and sales turnover. In the context of Tanzania, micro enterprises are those engaging up to 4 people, in most cases family members or employing capital amounting up to Tshs.5.0 million. The majority of micro enterprises fall under the informal sector. Small enterprises are mostly formalized undertakings engaging between 5 and 49 employees or with capital investment from Tshs.5 million to Tshs.200 million. Medium enterprises employ between 50 and 99 people or use capital in investment from Tshs.200 million to Tshs.800 million (URT, 2002).

Table 2.1 Segmentation of SMEs

Segment/characteristic	Loan Amount/Size In Million (Tsh)	Income/Sales Return Over Per Annum Million (Tsh)	Capital Invested (Net Worth In Million (Tsh)	No Of Employees
Small	1-10	20-100	5-50	<5-5
Medium	>10-50	>100-250	>50-100	>5-25
Large	>50-100	>250-500	>100-800	>25-100

Source: SME credit manual (2007).

Key: < Less than, > More than, - To

2.3 Theoretical Literature Review

This focuses on some of the concepts of financial institutions and the role they play in the development of SMEs. The concepts chosen are those that are in relation with the area of this thesis. The chapter opens with an overview of financial institutions. This shows the various products and services that FIs have and explain how they are of importance to the development of SMEs, and also the extent to which transaction cost affects the delivery of these products and services. The next centre of attention is SME growth and development. This gives an idea on how firms are considered by financial institutions before they are offered their services. The type of microfinance is of significant importance in getting the services. This is explained and further for a look is made into what determines the capital structure of a business. This will explain why some firms prefer borrowing to equity capital and vice versa. The next concern is to investigate why some firms face problems in getting loans. The report shows the theoretical links between microfinance and SME development.

2.3.1 Macro-economic and Policy Environment

The reforms introduced since 1986 have aimed at restoring macro-economic stability in Tanzania. In the process, however, the SME sector has been affected in many ways: In general, the political, economic and social environment is still biased against SME development. Macro-economic policy has improved considerably in

recent years in terms of stability and reducing various imbalances. However, there are still many problems relating to the challenge of managing the transition from a public sector led to a market oriented and private sector led economy. The institutions that are necessary for smooth functioning of the market are not fully in place. An attack has been launched against corruption but many SMEs are still losing part of their profits to corrupt public officials. The high degree of donor influence on the reform process continues to undermine efforts to co-ordinate SME development. Lack of adequate antidumping legislation made that, for example, import of second hand garments and other textiles in unlimited quantities has been systematically destroying the local small-scale textile industry. Devaluation has made both competing imports and imported inputs more expensive. It opened up new opportunities by introducing new SME product lines but firms in several branches have lost their market share to competing imports. The ongoing restructuring of public firms and Civil Service reform have released a labour force which is straining the labour market in the sector. Normally, these people have no alternative other than self-employment. This development has saved the incomes of the new entrants from total collapse but it has also reduced average returns to actors in the sector as a whole.

2.3.2 SME Policies in EAC and SADC countries

Tanzania's economy has made significant progress in fostering strong links with its neighbours, as part of the process of opening its economy to competition and complying with WTO regulations. SMEs constitute an important sector in terms of imports and a reduced number of them is also engaged in exporting products to the region. It is therefore of utmost importance to put Tanzanian SMEs in the capacity to compete successfully with SMEs from other countries that have already in place support mechanisms to foster their growth and enhance their competitiveness.

The Draft Treaty for the East African Co-operation (EAC) stipulates, among other issues, that partner states shall encourage the development of indigenous

entrepreneurs; facilitate the development of small and medium scale industries including sub-contracting and other relations between large and small firms; and promote special programmes for women in SMEs. Only Kenya has at the moment a working SME Policy, which was introduced in 1986 through the Seasonal Paper No. 1. Subsequent directives and development plans have been even more emphatic on this recognition: Kenya counts today with a policy framework that includes government agencies, service institutions, micro-finance entities, public research bodies, private sector consulting firms, and SME associations. Kenya's Seasonal Paper No. 2 set out a comprehensive policy framework of forms of assistance to the SME sector. There are already some positive indicators towards the development of the sector, although dynamism of Kenya's SMEs exists only among the micro category of SMEs (firms employing 1 to 10 workers). Kenya's policy -makers recognize that the contribution of companies with 10-49 workers is still small and attribute their slow growth to lack of an enabling environment for SME operators to expand their activities.

In the Southern Africa Development Community (SADC) the most advanced examples of SME policies are those of Mauritius, Namibia and South Africa: In Mauritius, SME Policy resulted from the enactment in 1993 of the Industrial Expansion Act and the subsequent Small and Medium Industries Development Organization (SIMDO) Act. Subsector policy measures have been also introduced in view of the rapid development taking place in the tourism sector, the need to foster regional co -operation and to build on the existing comparative advantages as well as to enhance the competitive edge of the manufacturing sector.

Mauritius is making significant progress to turn into a financial hub for the region, a major tourist destination, exporter of high value added jewellery and fashion articles to developed countries, and a printing and publishing centre for Africa. Special incentives for SMEs include duty exemption on imported production equipment and reduced corporate tax of 15% (instead of 35% applying to other type of firms). The

Export Processing zones play also a fundamental role in fostering SME development.

In Namibia, SME Policy is in place since 1997. The Government has assigned priority to six areas, namely finance, markets, training, technology transfer, purchasing, and sites and premises. Examples of subsidies and incentives are the establishment of a threshold for registration, setting up of Cash and Carry's in rural areas, preference in Government purchases, free information, market linkages and purchase assistance, etc. Other market-oriented support measures include a Vendor Development Programme, development of sites and premises, export market investigation, etc. The land issue and the question of licensing, however, remain as constraints that have to be addressed. In South Africa, the 1995 White Paper entitled "National Strategy for the Promotion and Development of Small Business" set up the basis for SME Policy. It identified two broad objectives: (a) the creation of an enabling institutional framework to increase access to both financial and non-financial support services for SMEs, and (b) the creation of a legal and regulatory environment that promotes the development of the sector. South Africa's SME Policy has been designed to redress the inequalities inherited from the past and empower indigenous historically disadvantaged entrepreneurs to compete with success in a white-dominated economy.

In 1996, the Government issued the Growth, Employment and Redistribution Macroeconomics Strategy (GEAR) that assigned to SME development a key role for employment creation and income generation. GEAR made explicit reference to the role assigned to SME support institutions such as the Centre for Small Business Promotion (CSBP), the Ntsika Enterprise Promotion Agency, Khula Enterprise Finance Limited and the National Small Business Council. Another fundamental aspect of South Africa's SME Policy is the reform of the Small Business Development Corporation (SBDC) and their transformation into a new public-private partnership denominated Business Partners (BP). BP, funded primarily

through shareholding contributions made by big business, has been recognized as an important instrument to foster linkages between established large and emerging small enterprises.

Beck *et al.* (2008; 2010) provide the first attempt to understand SME financing from the supply side. Based on a survey of 91 banks in 45 countries, the authors provide a characterization of bank financing to SMEs and find that banks perceive the SME segment to be highly profitable and serve it through a number of lending technologies and organizational setups. The authors observe few differences in the extent SMEs are reached out by banks based on their ownership structure (i.e. public, private or foreign-owned). However, they find significant differences across banks based in developed and developing economies, and conclude that the enabling environment is more important than the size of the firm or bank ownership in shaping bank financing to SMEs.

De la Torre *et al.* (2010) investigate banks' approaches to SMEs in terms of business models and risk management systems. Based on surveys for 48 banks and one leasing company in 12 countries, the authors find that all banks in the sample are interested in serving the SME segment. To do so, almost all have separate organizational units and offer a wide range of products, applying different transactional technologies such as credit scoring or risk-rating systems. The authors conclude that the conventional wisdom according to which large banks are not attracted by SMEs and that this business is dominated by small banks and based on relationship lending does not hold in practice.

In a similar study, Rocha *et al.* (2011) investigate the status of bank financing to SMEs in the Middle East and North Africa (MENA) based on a survey of 139 banks in 16 countries. The authors find that in spite of a positive perception of the attractiveness of the segment, the SME sector in the region remains largely underserved. Direct government interventions through public banks, credit guarantee

schemes and other forms of subsidized financing play a major role in SME lending, partly compensating for the low level of private sector involvement, which in turn reflects the MENA's weak financial infrastructure.

Finally, Stephanou and Rodriguez (2008) analyze both trend and structure of the SME financing market in Colombia. They find that banks in the country regard the SME segment as an attractive business opportunity though their level of sophistication in terms of business models and risk management tools remains modest. The authors conclude that the market is characterized by a number of institutional and policy constraints, which inhibits further growth of SME lending.

Ongoing efforts to study SME financing from a supply-side perspective are particularly relevant for Sub-Saharan Africa. According to enterprise-level data collected by the World Bank (various years), SMEs in Sub-Saharan Africa are more financially constrained than in any other developing region. Only 20 percent of SMEs in Sub-Saharan Africa have a line of credit from a financial institution compared, for example, with 44 percent in Latin America and Caribbean, and only 9 percent of their investments are funded by banks versus 23 percent in Eastern Europe and Central Asia. These findings alone provide the rationale for investigating the structure of the SME lending market in the region, with the aim to understand the main drivers and obstacles to SME financing as well as banks' operational approaches.

2.3.3 Tanzania SME's policy Review of 2003

The SME Development Policy 2003 was the outcome of a lengthy preparation process that followed a participatory approach. Zonal workshops conducted over the period 1998-2001 brought together the main stakeholders, resulting in a situation analysis of the key issues that were the inputs for the formulation of a draft policy document (2001/2002). Following a second round of consultations on the draft policy in 6 locations across the country, the policy document was finalized in

November 2002 and got Cabinet's approval in February 2003. The "owner" of the Policy is the Ministry of Industry and Trade (MIT) that led the preparation and formulation process, with the support of some development partners, namely Commonwealth Secretariat, UNIDO, and Department for International Development (DFID) and the US Agency for International Development (USAID).

According to Tanzania SME's review done by UNIDO (2013), the policy structure is built on 7 pillars with corresponding Policy Statements, namely: Legal and Regulatory Framework whereby the Government should enhance implementation of programs aimed at simplification and rationalization of procedures and regulations so as to encourage compliance and minimize transaction costs. Physical Infrastructure is also a pillar of SME policy whereby the Government has to continue to improve the physical infrastructures and provision of utilities in collaboration with Local Authorities, private sector and development partners. Business Development Services based on Entrepreneurship Development through facilitating improved access of SMEs to financial and nonfinancial services, Business Training by enhance the capacity of institutions providing business training to SMEs. Information is among of the pillar analyzed by the policy, the Government will facilitate and support programs aimed at increased access of information pertinent to the development of SMEs. Also, technology whereby the Government has to facilitate acquisition and adaptation of technologies as well as enhance networking between R&D Institutions and SMEs in a bid to upgrade technologies so as to raise the productivity and competitiveness of the sector and Marketing where the Government is committed to facilitating support programs aimed at improving SMEs' access to market (UNIDO, 2012)

According to UNIDO (2013), access to Finance was among of the pillar of the SME policy whereby the Government has to enhance financial reforms aimed at further liberalization of the financial sector and the creation of financial intermediaries to cater for SMEs. Institutional framework for SMEs development

was among of the pillar whereby the government has to strengthening institutions and associations supporting the SME sector. Also, Rural Industrialization by facilitating the establishment of manufacturing enterprises in rural areas so as to add value to agro products. The last pillar was Cross Cutting Issues which included Environmental considerations in all SME development interventions and Gender and the Disadvantaged Groups by ensuring gender mainstreaming enhanced in all initiatives pertaining to SME development.

2.4.4 Financial institutions support on business skills in Tanzania

Entrepreneurs

In the area of business skills training, the University of Dar es Salaam Entrepreneurship Centre (UDEC), Mzumbe University, Moshi University College of Cooperatives and Business Studies (MUCCoBS) and the College of Business Education (CBE) offer both long and short business courses, including entrepreneurship, as well as conducting consultancies in SME-related issues. Furthermore, the Vocational Education and Training Authority (VETA) offers training in many trades as well as basic business management skills. For example, VETA, in collaboration with the government of The Netherlands, will soon start a four-year pilot project in seven regions to train local entrepreneurs (Haule, 2006:i). The objective of the training is to enable the trainees to run their own businesses. In addition to business skills training offered by established training institutions, the government conducts training of small entrepreneurs through sectoral programmes. For example, small entrepreneurs are being trained at district level through the Agricultural Marketing Systems Development Programme (AMSDP) (Government trains small entrepreneurs, 2006:5). The objective of this training is to strengthen the private sector by enabling small entrepreneurs to identify markets for their commodities. It is expected that the training will help small entrepreneurs to seize business opportunities that would otherwise be missed.

As for funding mechanisms, the government has established several schemes aimed at promoting SMEs while at the same time addressing issues related to poverty and employment problems. They include the National Entrepreneurship Development Fund (NEDF), the Youth Development Fund (YDF) both under the Ministry of Labour and Youth Development and the Women Development Fund (WDF) under the Ministry of Community Development, Gender and Children (URT, 2003a: 11-12). Besides these government schemes, other programmes have been established with donor support, for example, the Small Entrepreneurs Loan Facility (SELF) financed by the African Development Bank (ADB), the National Income Generation Programme (NIGP), the Presidential Trust Fund (PTF) and the Community Development Trust Fund (CDTF) (URT, 2003a: 12).

2.3.5 The Link between MFIs and SMEs

Several objectives so conceived by the government of Tanzania influenced the initiation of the MFIs schemes, among them, the most commonly mentioned ones include: poverty alleviation and improved living standards, offering financing to the poor (Harper *et al.*,1999), women's empowerment (Rahman, 1999), and the development of the business sector as a means of achieving high standards and reducing market failure (Chijoriga and Cassimon, 1999).

2.4 Empirical Evidence

Many Studies show that SMEs are more constrained by financial and institutional underdevelopment. Antony (2005) in his study of problems and prospects of SMEs in Nigeria, recommended that government through its Central Bank should establish the National Credit Guarantee Scheme for SMEs, which should guarantee at least 80% of loans needed by small and medium enterprises. This shows that access of capital or funds is very crucial to SMEs development. Thus, a need to conduct study on finance linking with SMEs development was very important. Therefore, this study intended to research on the influence of financial institution to SME's development.

2.4.1 Importance of Small and medium Enterprises in Tanzania

In Tanzania context, the small and medium enterprise policy of 2002, explains the importance of SMES to the Tanzanian economy, while at the same time highlighting the lack of support that SMEs have received in the past. From the Haki Kazi study (2005) it is revealed that the SME sector in Tanzania presently accounts for about a third of Gross Domestic Product (GDP). There are about 1.7 million SME businesses. These employ about 20% of the workforce. SMEs in Tanzania are particularly attractive as engines of development in that, they are relatively easy to set up even in rural areas, the low level of investment for every job created makes them potentially attractive to financiers and they act as a training ground for entrepreneurs and thus set the foundations on which future industrial growth can be built.

2.4.2 Current support institutional framework

According to UNIDO (1997), the supportive business environment for SMEs is still weak in Tanzania. The SME support programmed are poorly co-ordinate and lack the necessary coverage to reach all sectors of the small business community. Almost all micro-finance institutions (MFIs) cater for those firms with credit requirements below Tshs two million. Project lending and risk capital for SMEs is virtually unavailable. The private equity and venture capital funds established in Tanzania are few and cater primarily to the needs of expansion of established business and privatized companies. The main entities/programmes that constitute the current support framework of financial services are the Small Industries Development Organization (SIDO); the National Income Generation Program (NIGP); Pride Tanzania; Mennonite Economic Development Associates (MEDA); the Kilimanjaro Co-operative Bank (KCB); the Savings and Credit Co-operatives (SACCOs); and the National Micro-finance Bank (NMB). The major provider of industrial support and advisory services are SIDO, TIRDO, CAMARTEC, IPI and TBS.

The Government is currently not supplying budgetary support for developmental activities in these organizations. Business and vocational training are covered by a number of institutions. VETA is the most important vocational training institution in the country. In the area of advocacy towards policy changes, SIDO has been the main institution that, traditionally, advocated before the other branches of the Government on behalf of SMEs. Private sector institutions (TCCIA, CTI, etc.) are also advocacy entities on behalf of SMEs but their outreach is still limited. They are actively encouraging and promoting membership and ensuring that the organizations are adequately financed through member fees and donor-sponsored programmes aimed at building capacity. A new umbrella organisation in support of small industries, the Tanzanian Federation of Small Industries Organizations (TAFSIO), has been recently established. Self-help organizations of micro-entrepreneurs have been also taking over advocacy roles during the last years (UNIDO, 1999).

2.4.3 The banking and finance structure

Although the Tanzanian financial system comprises a host of both formal and informal organizations, adequate finance is not being provided to allow for the development of the sector. In both the 1991 and 1995 Informal Sector Surveys, lack of capital was cited as most pressing need of the SME operators. The surveys further indicate that working capital (necessary for business growth) was the most needed followed by investment capital (for starting up new business). Access to finance is limited by a number of reasons: Bank restructuring is taking place but most banks do not operate an SME financing window. The National Micro-finance Bank has great potential but it is practically not operational as yet. Bank staff is still inexperienced in issues related to small loans and micro-finance. Some of the banks operate in limited geographical areas and it has become even more restricted after the banking restructuring. There is lack of a guarantee scheme to back up bank financing to SMEs and entrepreneurs are unable to fulfill the collateral requirements. This is a reflection of the inflexibility of the bank and other financial institutions. Where this requirement has been relaxed (e.g. Pride Tanzania Ltd) successes have been

recorded. There is low capability of borrowers to prepare and present applications that meet bank requirements. It is too expensive to hire professional services for doing this job for SMEs. There is still a widespread perception of a high risk of business failure of small enterprises. This is a reflection of the lack of information or the perceived high cost of collecting such information on SMEs (UNIDO, 1999).

2.4.4 Role of financial institutions in Tanzania

Financial institutions in Tanzania have operated under a competitive financial system between 1961 and 1967. The same institutions faced a turnaround in 1967 into financial repression. It was a highly regulated and specialized financial system with government intervention in the context of a centrally planned system. High inflation and negative interest rates were common. The system was geared to serve more the public sector at the expense of the private sector. With the onset of economic reforms in 1984, the economy's direction began to move away from the tenets of a centrally planned economy towards free-market orientation. In 1991 financial sector reforms became a reality. In their current set up financial institutions are divorced from the struggle for poverty alleviation. They are least involved in direct poverty alleviation and only marginally involved in indirect poverty alleviation (Mwandenga, 2009).

2.4.4.1 Sources of finance for SMEs

There are numerous potential sources of finance but SMEs encounter problems in accessing them. This has been due to stringent conditions including the need to be formalized, high interest rates, lack of collateral and highly bureaucratic loan procedures. Literature indicates that most SMEs are owner-financed. The start-up and operating capital are mainly from the pocket of owner(s) of a particular enterprise. The sources of these finances are in most cases from meager personal savings. They are relatively small amounts of money in the context of having strong, dynamic, vibrant and competitive SMEs in our globalized world. In general SMEs are owner-financed and/or financed by informal money-lenders and consequently a

relatively low capital base. URT (2002) argue that Banks have not been willing to lend to SMEs. This has made SMEs' access to finance problematic. According to a study by Iramba Management and Industries Services Ltd (2003) cash may not be the main problem in as far as credit programmes for SMEs are concerned. However, cash appears to be an important consideration for which many SMEs genuinely need assistance from the government or financial institutions (Ogutu *et al.*, 2006)

2.4.4.2 Financial facilities

Almost all micro-finance institutions (MFIs) in Tanzania cater for those enterprises with credit requirements below 2 million Tshs. There is almost nothing for enterprises with requirements of between Tshs 3 and 10 million (the “missing middle”). Beyond Tshs 10 million, companies with adequate collateral can access bank credit, although it tends to be short term and conservatively managed.

Project lending and risk capital is virtually unavailable from commercial banks. The private equity and venture capital funds established in Tanzania are few and cater primarily to the needs of expansion of established business and privatizations, although some are increasingly paying attention to fast-growing SMEs. The main institutions and programmes that constitute the current support framework of financial services are the following:

2.4.5. Small Industries Development Organization (SIDO)

SIDO was set up to provide credit and business advisory services to small-scale manufacturers and was traditionally funded through donor programmes. SIDO is now finding itself under funded. This had a negative impact on the credit operations, gradually reducing the capital base of SIDO's revolving loan funds. The gradual decline of SIDO has resulted in the loss of one effective source of financing for SMEs (UNIDO, 1999).

2.4.6. The National Income Generation Program (NIGP)

NIGP is a trust fund set up by the Government with the support of UNDP and other donors. It was designed to strengthen existing micro-finance institutions (MFIs) through programmes of technical assistance both in rural and urban areas. Its main objective is poverty alleviation through income generation and employment creation. The three areas of intervention are agriculture and rural development, infrastructure and small businesses. As a further step, NIGP is currently working with private banks to establish a credit guarantee fund that aims at easing access to credit to those companies that “graduate” from its support programmes and become candidates to bank credit (UNIDO, 1999).

2.4.7. Pride Tanzania

This is the largest MFI established in the country. It is based in Arusha and is supported by PRIDE Africa. It has the largest client base of any MFI, with more than twenty thousand members. It uses the village banking methodology that was developed by the Grameen Bank in Bangladesh. It hopes to eventually become a national micro-finance bank as early as possible. However, it has a very long way to go in terms of achieving even the basic level of operational stability and financial sustainability. These include covering the cost of borrowed capital from commercial sources and other factors such as depreciation, training, marketing and development costs, as well as the cost of inflation.

2.4.8. Mennonite Economic Development Associates (MEDA)

MEDA operates two small credit facilities in Dar es Salaam and Mbeya. In addition to own resources, MEDA gets funds from the NIGP for on lending to smaller MFIs. MEDA has been supporting SIDO’s credit schemes for Kilimanjaro, Arusha and Mara regions (including capacity building). The majority of MEDA clients are in trading businesses although a few are in production (especially in agriculture). Whereas MEDA caters for micro-enterprises, its future focus will also be on small enterprises with growth potential. In pursuing a policy of indigenisation, a local

NGO (“Huduma za Maendeleo”) has been established to take over the services of MEDA in the future. Following experiences developed in other countries, MEDA will then engage in developing non-financial services (e.g. marketing) for SMEs.

2.4.9 Savings and Credit Co-operatives (SACCOs)

Officially, there are more than 1,000 SACCOS in Tanzania but World Bank researchers found that less than 30 of them could be described as being active. The SACCOs, originally established with support from the Ministry of Agriculture and Co-operatives, proved to be good savings institutions but they have not been effective in terms of lending. Although the SACCOs show some promise, the level of effort that would be required to re-establish this network is quite high. However, some limited interventions appear to have a positive impact. The Kilimanjaro Co-operative Bank (KCB), which was established with support from DANIDA and the leading development bank in Holland, has been serving as an on-lending and training institution to the SACCOs in Kilimanjaro and Arusha. The ability of organizations like the KCB lack the national reach and resources required to extend these training and supervisory services to other MFIs without a major injection of capital and technical support from donors (UNIDO, 1999)

2.4.10. Role of National Micro -finance Bank (NMB) to SMEs

NMB is currently serving as a savings and financial services window for the rural and urban poor. It expects to begin lending to SMEs in 2000, first on a short-term commercial basis and eventually to extend its services to include term lending. The NMB, which emerged as a spin-off of the National Bank of Commerce, is still under capitalized but aims to be eventually privatized including the participation of donor agencies and individuals or groups of customers of the bank. NMB’s strength is its extensive branch network, which could serve as back up of other micro-finance operating units, such as community banks, SACCOs, trusts, development associations, producer and consumer cooperatives, etc.

2.4.11. Role of CRDB Bank Plc to SMEs

Formerly the Co-operative and Rural Development Bank, it was recently reconstituted after several years of losses and purchased by DANIDA, local investors and more than 12,000 individual stakeholders. It operates a network of more than 20 branches throughout the country and is a major provider of financial services in rural areas. CRDB has been an important factor in the development of flower cultivation in the Kilimanjaro area, but has halted for the moment term lending pending strategic adjustments and access to new development finance funding.

2.4.12 Other Micro-finance Schemes

There are a number of formal and informal programmes that provide special services to SMEs. For example, the one sponsored by the European Union, which backed financial support through grants to the poor in rural areas. Three years after the programme was launched in four major regions of the country, it is now being redesigned. One of the reasons that the programme failed was its lack of support to new business ventures. Providing money without business advisory services to new entrepreneurs contributed to a high failure rate. A second weakness of the programme was that it hurt other microcredit programmes that were trying to operate on a cost recovery basis at market interest rates. Eventually, the EU programme will on-lend to establish MFIs/NGOs and chartered banks that are willing to lend to small enterprises.

2.4.13 Characteristics of Microfinance Institutions (MFIs)

Microfinance and its impact go beyond just business loans. The poor use financial services not only for business investment in their microenterprises but also to invest in health and education, to manage household emergencies and to meet the wide variety of other cash needs that they encounter. The enormous success of few MFIs speaks volumes about the difference that MFIs can bring about in lives of the poor mass (Bikki and Joselito, 2003). Perhaps the most well-known and studied MFI is the

Grameen Bank of Bangladesh. Founded in 1976 by the Nobel laureate Muhammad Yunus, it has been modeled by other MFIs around the world. As of December 2009, The Grameen Bank reported 7.97 million borrowers, 97% of whom were women. The total funds dispersed by the Grameen Bank since its inception is US\$ 8.74 bio. The Grameen Bank reports a loan recovery rate of 97% (ibid). These small informal groups apply together for loans and its members act as co-guarantors of repayment and support one another's efforts at economic self-advancement.

Evidence from the millions of microfinance clients around the world demonstrates that access to financial services enables poor people to increase their household incomes, build assets, and reduce their vulnerability to the crises that are so much a part of their daily lives (Chijoriga, 2005). Access to flexible, convenient, and affordable financial services empowers and equips the poor to make their own choices and build their way out of poverty in a sustained and self-determined way. It is a widely accepted fact that Microfinance in a poor country like Tanzania is probably the best solution for poverty alleviation and inclusive growth. 31 percent of Tanzania's population lives below the poverty line and microfinance can play a vital role to raise the living standard of people at a faster rate (Kazi, 2003).

In most cases, microfinance and MFIs are supported by grant funding. In order to achieve scale and viable business operations, we need capital infusion and funds / loans available in a larger and more organized manner. At present, commercial banks have been channelizing funds into MFIs to fulfill mandatory requirement only. MFIs play a very important role in reaching the masses (Kimei, 2001). MFIs capitalize on their local branch network and close proximity with their clients. The range of services offered by them includes loans, savings facilities, insurance, transfer payments, and even micro-pensions to the poor masses who cannot afford to enter to the formal system of commercial banking. MFIs employ staff from local population, possess extensive data about the clientele, have deeper relationship with the clients and can operate much efficiently than a commercial bank in that area.

Financial Inclusion is a larger concept than the microfinance business. MFIs with their outreach and contacts can play a very proactive role in furthering the Financial Inclusion agenda. Essentially therefore, in the ecosystem of financial inclusion, both commercial banks and microfinance institutions must co-exist cohesively if one would like to achieve the goals set for financial inclusion.

In Tanzania, Microfinance is distributed primarily through MFIs (including micro credit banks, NGOs, cooperatives etc), to the help rural groups directly. The participation of commercial banks is limited to the role of a wholesale lender to the MFIs. MFIs also have access to the funding from Donor Agencies and Government as well. In such a situation, it is absolutely imperative that MFIs and commercial banks work in tandem, complementing each other rather than competing with each other, and capitalize on each other's position in the market (Chijoriga, 2000). It is more practical, efficient and effective to lend to the intermediaries (MFIs) who would in turn lend to the final beneficiaries. The MFIs thus can become extended arms of the banks to achieve the larger objective of financial inclusion which banks find difficult to achieve solely. Rural clients like to have micro savings and micro credit products from one source. So, MFI can play an agent role or a point of contact for a commercial bank with the rural masses.

It would be more commercially viable proposition for commercial banks to approach the rural poor through MFIs rather than opening their own branches. Other measures could include providing "Business Correspondent" status to MFIs. This would help banks distribute their products and services to the masses through these MFIs. Rather than competing with each other, collaboration is a win-win situation for both commercial banks and MFI's as banks are looking for a footprint while MFI's for source of funding.

A successful MFI is one that maintains strict client repayment schedules (Morduch, 1999). Weekly repayment schedules and the local knowledge of the staff at village banks enable MFIs to keep close track of who is repaying loans and who is not. Such strictness is necessary even if the loan is late by a single day. The downfall of many MFIs is lenience; often clients do not repay their loans on time. Leniency teaches clients that it is not necessary to repay loans on time, and that the MFIs are “soft” and easy to supplicate. An MFI with weak control over repayment schedules would be unlikely to succeed.

Additional functions of a strict weekly repayment schedule are to remind the people of their debt to the bank, and to catch problems early on if there is a client who may have difficulty repaying (Rhyne, 2001). A second innovative practice adapted by MFIs is group lending. The function of group lending is to make up for the lack of collateral in impoverished communities (Morduch, 1999). Initially, microfinance was attacked by critics who argued that banking cannot be done without collateral. Poor people typically do not have collateral to put up in case of failure to repay their loans, therefore, they were assumed to be unbendable. It has since been demonstrated that group lending can be used in the place of concrete collateral.

In group lending, the loan is made to a self-selected group of approximately five villagers who may or may not be involved in the same business enterprise. A group treasurer is elected among them to collect weekly repayments and deposit them at the village bank (Brandsma and Chaouli, 1998). Another important ingredient in the trust system is personal relationship between MFI staff and clients. The small staff at the village bank is encouraged to get to know clients on a friendly basis. Owing to the fact that clients do not put down collateral, the loan is based entirely on trust. Loan officers in particular, after spending much time with the people of a village, are able to determine who can be trusted to repay a loan and who cannot. This approach helps to weed out potential problem clients (Morduch, 1999).

One of the unique features of microfinance is high interest rates. While a regular financial institution may charge 10-15% interest on a loan depending on credit history of the borrower, MFIs charge interest rates of 40-60% (Morduch, *ibid*). There is much arguing among different microfinance programmes on the effectiveness of charging high interest rates. Some experts say that high rates discourage the poor from borrowing, and take away a significant portion of their profits if they are able to successfully start a business; however, no research has been able to prove that high interest rates discourage the poor from borrowing. In fact, the statistics show that MFIs can obtain a repayment rate of 98.7%, even with high interest (McNelly and Dunford, 1998). High rates encourage people to put a lot of effort into their business, since they will need to work very hard in order to still make a profit after the loan is repaid; harder work usually pays off with a higher success rate for the businesses. Also, 50% interest isn't terrible when the loan is repaid in small weekly increments. High interest rates are necessary in order for a microfinance institution to become sustainable (Brandsma and Chaouli, 1998).

Some experts estimate that only 1% of microfinance institutions are fully sustainable and only 5% ever will be; the vast majorities rely heavily on subsidies and government grants (Morduch, 1999). Marguerite Robinson, a pioneer of microfinance, and author of *The Microfinance Revolution*, explains subsidy reliance: Let's assume that the only objective we care about is maximizing benefit to poor people. Although the ultimate goal of an MFI is financial viability, all MFIs need to start out with subsidy. Subsidy can come from individual donors, government grants, or private institutions, but it must be steady and reliable (Morduch, 1999).

During the first five years or so a new MFI will rely heavily on subsidy in order to cover high operational costs, and low profits from loan repayment. Low profit does not mean that clients are not paying back their loans; rather it indicates that the MFI does not yet have enough clients to cover costs. Many MFIs have chosen to remain permanently dependent on subsidy in order to provide low interest rates to their

clients, and also to have a backup pool of money in case of economic disaster (Morduch, 1999).

2.5 Conceptual Framework

Conceptual framework is a set of broad ideas and principles to be taken from the various studies and intend to use them to structure the presentation of subject under this research topic. This includes the dependent variables (development which will be measured by employment creation, total asset in the current period and sales turnover or profitability, income growth, higher production of quality goods, higher supply, technology development, ability to pay SME bills) and independent variables (determinant factors of indigenous SMEs development which can be measured by financial institutions and SMEs age by number of years in business, age, sex, marital status, and education (Yasuda, 2005). SMEs' size by the total assets in previous period (Honjo &Haradar, 2006) 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 with normal banks, as they are unable to provide adequate collateral.

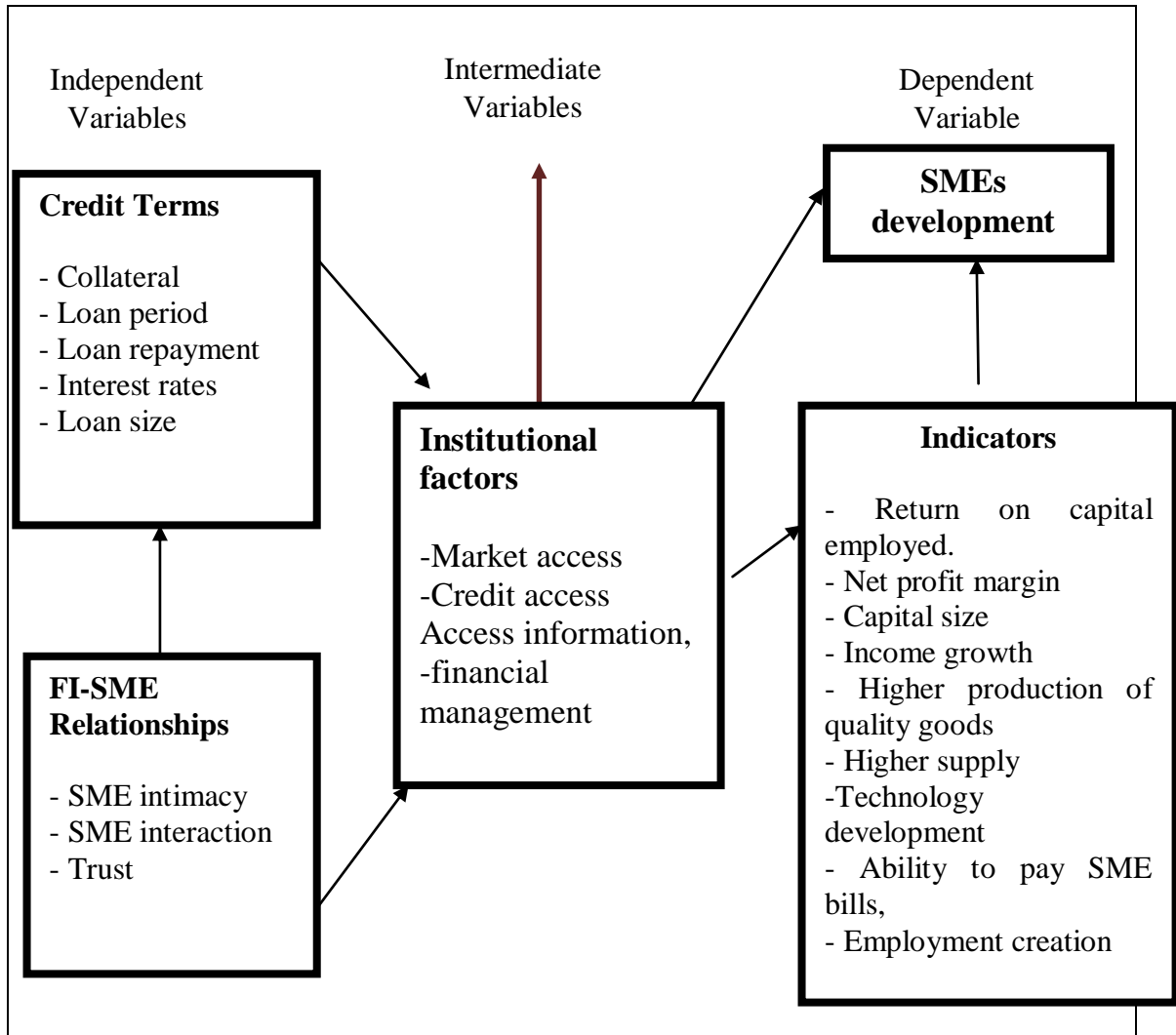
The lack of skills is not what makes people poor. Aid is not the aid is not the answer to poverty, but only it helps poverty to continue. It makes dependency and takes away the people's initiatives to break through poverty. Unleashing of creativity and energy in human being is the answer to poverty." (Yunus, 2003)

Microcredit is an 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 these reasons they can't even meet the minimal qualifications for an ordinary credit. By helping people with micro

credits 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.

The sketched conceptual framework shows that SME's development depends from different factors but financial support (loans, cash management advice technology and information) seem to be a big factor for the development of SME's whereby together with institutional factors (Market access, credit access, access to information and financial management) lead to higher production, higher supply, technological development, ability to pay SME's bills, employment creation and income growth which present SME's development.

Figure 2.1 Conceptual Framework



SOURCE: Constructed (2013)

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Description of the Study Area

Morogoro is one of the regions of Tanzania mainland. The region lies between latitude 5⁰ 58" and 10⁰ 0" to the South of the Equator and longitude 35⁰ 25" and 35⁰ 30" to the East. It is bordered by seven other Regions; Arusha and Tanga regions to the North, the Coast Region to the East, Dodoma and Iringa to the West, and Ruvuma and Lindi to the South. The Region is administratively divided into 6 districts councils including; Mvomero, Kilosa, Kilombero, Ulanga, Morogoro Urban (Municipal Council) and Morogoro Rural (URT, 1997). This study was conducted in Morogoro Municipality specifically in 3 divisions namely Sultan Area, Chamwino, and Mwembesongo. The choice of this study area was due to existence of many SMEs in the area. The Municipality is located centrally in the region which is divided into, nineteen wards. The main economic activities of Morogoro Municipal Council are farming, livestock keeping and business.

Apart from the large number of small and medium enterprises, Morogoro municipal council was selected for the study for two other reasons. First, it is the fifth most important industrial and commercial city in Tanzania mainland. Second, most of SME's owners are living and working nearby financial institutions at the Municipal Council. Also, many financial institutions are located in Morogoro Municipality than to other district like Mvomero district though both districts have SME's; the latter was preferred for the following reasons. Firstly, the difference between the two was only one participant. Secondly, Morogoro municipality is more important industrially and commercially than Mvomero and Morogoro rural. For example, although both Morogoro and Mvomero district have the SME's, Morogoro is ahead of Mvomero district on selected parameters such as number of employees, SME's and financial institutions (URT, 2003c: 17). Fourthly and lastly, Morogoro

municipality is larger than other districts with a population of 263,920 while Mvomero district has a population of 106,668 only (URT, 2003b: 59 & 99).

3.2 Research Design

A cross-sectional research design was used, the design allows collection of information at one point in time and data collected can be used for descriptive purposes as well as for determination of relationship between and among variables (Saunders, 2007). The choice of the method was based on its ability to meet the objectives of the study and also due to limited resources in terms of time and budget.

3.3 Population and Sample Size

3.3.1 Population

The study covered 5863 registered and licensed SMEs in Morogoro municipality. The target population of this study was entrepreneurs and financial institution officers in Morogoro municipality.

3.3.2 Sample Size

The study took a sample of 60 SMEs were selected by using simple random were by selected three wards that Sabasaba, Sultan area and Uwanja wa ndege twenty 20 SME selected from each ward. Therefore the Sample size of this study was 60 respondents.

3.4 Sampling Technique

Both simple random and purposive sampling methods were used. Purposive sampling was used to select 3 wards of Sabasaba, Sultan Area, and Uwanja wa ndege; these wards were purposively selected based on the criteria of having higher concentration of SME's owners and financial institutions. Simple random sampling was used to select 60 respondents for interview and financial institutions as key informants.

3.5 Units of Inquiry

Respondents included in the research sample were departmental manager of business banking and other staff, loan officer, marketing officers and customers were interviewed whereby information about the type of support they provide to SME's, the researcher distributed the same questionnaires to the loan departmental managers, other staff members, and SMEs customers and SMEs non customers who were regarded as the research sample. The information collected were their views on the impact of development of SMEs as the sampling units of the study. The information which was obtained was about the type of support they obtained from the financial institutions, problems they face when accessing financial support, and their suggestions towards SMEs' development.

3.6 Data Collection

Both unstructured and structured questionnaire were used. A structured questionnaire with both close and open-ended questions were designed and used for this study to seek information from the respondents in relation to the support of financial institution to SMEs development, as well as challenges faced by SME's in obtaining financial support from financial institutions.

3.6.1 Primary Data

These were raw data collected direct from the field which included both qualitative and quantitative data. The scheduled interview was used in collecting primary data in this study.

3.6.1.1 Schedule Interview

In this method of data collection administered interview questions were used as a tool. Closed and open-ended questions were used to collect quantitative data from the respondents through schedule interviews.

3.6.1.2 Participatory Observation

This was where the researcher herself took part within the organization itself. This enabled the researcher to observe a number of things that were facts and important in achieving the objectives of the study. The researcher observed by looking at the location of the business, the number of employees and the activity they were doing and reviewing financial records. The researcher used this method because before accessing loans most of financial institutions have the tendency of visiting business areas to see location of the business, assets of the businessman/women.

3.6.2 Secondary Data

The researcher used the documentation in the due course of trying to search for the secondary data to accomplish the findings as follows.

Documentation:

Information was obtained from the materials, which were relevant to the problem of the study. The documentary sources used include the annual reports; pamphlets published and unpublished materials, handouts and journals.

3.7 Data Processing and Analysis

Data collected through the questionnaire were coded and analyzed using Statistical Package for Social Sciences (SPSS). Descriptive analysis was carried out to obtain means, percentages and frequencies to examine the influence of financial institution in the development of SME.

CHAPTER FOUR

RESULTS AND DISCUSSION

4.1 Introduction

This chapter is concerned with researcher's results, which most of them are discrete series, continuous series and categorical data. Data were presented in charts, frequencies and percentages. These data contain the characteristics besides the ones related to specific objectives; a) finding out the existing financial institutions financing SMEs in Morogoro Municipality; b) determining the extent to which financial institutions have helped to finance SMEs in Morogoro Municipality; c) determining constraints facing SMEs towards financial institution support. Data were collected by the researcher in the field surveying using tools such as direct observation, interview and checklist that were administered through structured questionnaires to the sampled respondents.

4.2 Characteristics of respondents

4.2.1 Age

Table 4.1 shows that out of 60 respondents 53% of SME's owners were found to have an age of 21 to 30 years, followed by 35% accounted for the age between 31 to 40 years. Also, 5% were SME's owners with age of 41 to 50 followed by 3.3% accounted for the age between 0 to 20 and 3.3% of SME's owners were found to have the age over 51 years. In this case, the SME's owners who fall in the age between 21 to 30 years has not opportunity to access financial support from financial institution because most of them do not have guarantor such as title deeds of land, houses and money to corrupt officials to access land, followed by the age group between 31 to 40 years of SME's owners which at least are in the high opportunity of accessing financial support because most of them started to fight life earlier than those of the age between 21 to 30 therefore they have guarantor such as land, and house title deed for loan application. The age group between 41 to 50 years comprise

SME's owners are at high opportunity of getting financial support because they can meet the criteria by having a lot of requirements needed by the financial institution while SME's owners with age of 0 to 20 and over 51 years are at high risk to access loans due to lack of criteria like title deed of land and houses. Therefore, the influence of financial institutions to the development of SME's is still poor due to pressing and expensive conditions which do not favors much SME's development.

Table 4.1: Age of respondents

Age (years)	Frequency	Percent
0 - 20 years	2	3.3
21 - 30 years	32	53.3
31 - 40 years	21	35.0
41 - 50 years	3	5.0
over 51 years	2	3.3
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.2.2 Sex of respondents

Table 4.2 shows that, from the study area the sex of respondents who were interviewed 55% of SME's owners were male and 45% were female. In this case male SME's owners have high opportunity of accessing loan because they are household heads owning land and big assets of the family, this made them easier to reach the conditions provided by financial institutions. Due to lack of ownership of big assets like land, most of women who are SME's owners fail to access support from the financial institution. Women-owned businesses appear restricted in their growth paths. Women's entrepreneurship is largely skewed towards smaller firms.

For example, these results are consistent to IFC (2011) whereby, women entrepreneurs are also more likely than their male colleagues to be in the informal

sector, running smaller firms mainly in service sectors and thus operating in lower value added sectors.

In addition, they operate more home-based businesses than do men. Access to finance for women is limited by nonfinancial barriers. Non-financial barriers can include conditions in the broader business environment that may differentially affect women’s and men’s businesses (e.g., the legal and regulatory environment or the quality of available infrastructure); personal characteristics of the entrepreneurs (e.g., differentials in education or management training); constraints within financial institutions (little familiarity with and cultural barriers preventing interest in female clients); and a financial infrastructure that limit incentives to reach out to more female clients (i.e., lack of credit bureaus or collateral registries). (IFC, 2011). Therefore, financial institutions are bias in their conditions which hinder women SME’s to have small opportunity of accessing financial support. Thus the influence of financial institutions to development of SME’s is still poor.

Table 4.2: Sex of Respondents

Sex	Frequency	Percent
Female	27	45.0
Male	33	55.0
Total	60	100.0

SOURCE: Constructed from primary data (2013)

2.2.3 Education level of Respondents

The level of education is the key factor of determining the decision of the person, record keeping and management of the business. Among 60 respondents interviewed, 29 respondents (48%) of the total respondents were the ones who got secondary education, 28 respondents (46.7%) got primary education, 2 respondents (3.3%) had got diploma level while 1 respondent (1.7%) attended higher learning education.

Table 4.3 shows that 48% of SME's owners had secondary education, this group have higher opportunity of accessing financial support because they can keep records, and manage well the business as one among the procedures done by financial institution before providing loan to SME's. Also, 48% of SME's owners who have got primary education are at high risk of not accessing financial support from the financial institution due to poor record keeping and business management while 3.3% of respondents who have got diploma education and 1.7% of respondents who have got higher education have great opportunity to access financial institution including chance to attend trainings which is sometimes facilitated in English language, and have good reputation in record keeping. Therefore, the influence of financial institutions to development of SME's owners who have primary and who are not yet educated is very poor due to systems and conditions made by the financial institution.

Table 4.3: Education level of the Respondents

Education level of Respondents	Frequency	Percent
primary education	28	46.7
secondary education	29	48.3
diploma level	2	3.3
Higher learning education	1	1.7
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.3 Details on the Nature of Business

4.3.1 Nature of the business at the start

About 81.7% of SME's owner's nature of their business was service oriented while 18.3% of SME's owners natures of business involved in this study were product oriented (Table 4.4). Due to lack of capital, market information and management skills from the financial institutions (81.7%) who are the most of SME's opted to provide services which do not need big capital such us barbershop, local food vendors, culture ornaments and soft drinks. 18.3% of SME's owners opted production as nature of their business because at least they can buy machines or any form of capital to invest in business which needs high capital. This hinder most of the SME's not to compete in the market due to poor production of their services.

SMEs are particularly constrained by gaps in the financial system such as high administrative costs, high collateral requirements and lack of experience within financial intermediaries. Increased access to finance for SMEs can improve economic conditions in developing countries by fostering innovation, macro-economic resilience, and GDP growth.

Therefore, influence of financial institution to development of SME's is still very poor because has closed the door of capital, management skills and market information to win competitions of their commodities and preference of the customers.

Table 4.4: Nature of the business at the start of the business

Nature of business of respondents	Frequency	Percent
product oriented	11	18.3
service oriented	49	81.7
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.3.2 Number of Employee employed by respondents at the start of business

The number of employees is determined by the level of an enterprise as well as capital which the owner has to invest in the business. Also, other businesses need a big number of people so as to improve the business which was seen as a big challenge to most of respondents of this study who failed to keep the required number of employees. Table 4.5 shows that out of 60 respondents, 56 SME's owners (93.3%) started with 1 to 4 employees, while 4 SME's (6.7%) started with 5 to 50 employees.

This study is correlated to World Bank Enterprise Surveys which revealed that, for example, in low-income countries, on average 43% of businesses with 20 to 99 employees' rate of access to finance or cost of finance as a major constraint to current operations. In high-income countries, only 11% of businesses of the same size rate access to finance as a constraint. The total financing gap for formal SMEs outside the high-income OECD countries is indicatively and preliminary estimated to be potentially as high as US\$700-850 billion (Dalberg, 2011). Small firms consistently report higher financing obstacles than medium and large enterprises (Beck, Demirgüç-Kunt, Laeven and Maksimovic, 2006). Smaller, younger and domestic- (as opposed to foreign-owned) enterprises report higher financing obstacles even after controlling for other firm characteristics. The relationship is not only statistically but also economically significant. The probability that a small firm lists financing as a major obstacle (as opposed to moderate, minor or no obstacle) is 39% compared to 36% for medium-size firms and 32% for large firms. (Beck, 2007)

This shows how the financial institutions have very little influence of developing SME's. Financial institutions should provide skills to SME's on how to manage business including employees in order to get higher return, also should provide

capital which will help SME's to employ enough employees so as to get quality goods regarding the level of the business.

Table 4.5: Employee at the start of the business

No. of employee at business start	Frequency	Percent
1 -4	56	93.3
5 – 50	4	6.7
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.3.3 Amount/capital which respondents used during the startup of the business

The startup capital has great influence to development SME's. As the research findings summarized in Table 6 indicate, about 38% of the total respondents started with the capital of 501,000 to 1,000,000 shillings, which most of them borrowed from financial institutions, followed by 33.3% of the respondents who started with the capital of 101,000 to 500,000 shillings. Also, 26% of SME's owners were able to start business with the capital of over 1,000,000 shillings, while 1.7% of SME's owners started business with the capital of below 100,000 shillings.

In this case, most of SME's who started with big capital as it was seen in the findings (38%) of SME's owners are in good chance of accessing financial support from the financial institutions because the institution believe that the SME which started with big capital can grow faster that those with small capital. As it was depicted in this study, only 26% of respondents started business with over 1,000,000 shillings as capital. Therefore, development and chance of accessing capital to 1 (1.7%) is too small. Banks are not adequately providing SMEs with capital in developing countries.

For example in the report on “Support to SMEs in Developing Countries through Financial Intermediaries”, these results are consistent with Dalberg (2011) that, there is large financing gap for SMEs in developing countries. The top five banks serving SMEs in non- OECD countries reach only ~20% of formal micro enterprises and SMEs.53, in Sub-Saharan Africa, this number is even lower, at 5%. Nearly 25% of SMEs in emerging markets have a loan but are financially constrained, and almost 60% do not have a loan overdraft, but need one. This deteriorated further during the 2008-2010 financial crises.

The study reveals that, there is less influence of financial institutions to the development of SME’s. Therefore financial should put clear environment to SME’s so as to access support from MFI’s.

Table 4.6: the startup capital of the respondents

Startup capital of respondents	Frequency	Percent
Below 100,000/=	1	1.7
101,000/= to 500,000/=	20	33.3
501,000/= to 1,000,000/=	23	38.3
Over 1,000, 000/=	16	26.7
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.3.4 Legal status of the business of the Respondents

This was very important aspect to this study because it carries the main theme of business environment of this study. Table 4.7 shows that out of 60 respondents, 55 respondents (91.7%) started business informally; means without formal registration, having vision or mission, business license and constitution. Only 5 respondents (8.3%) started business formally. These results are consistent to Klapper, Laeven and Rajan (2006) that, different elements of the business environment affect economic

growth through the entry of new firms. Specifically, high firm registration costs hamper new firm creation and growth, while property right protection and regulations fostering access to finance are conducive to firm creation and growth.

The effect of policies might also explain the absence of a robust relationship between the size of the SME sector and growth, as a comparison between Italy and the UK illustrates. On the one hand, Italy has high registration costs and many old, inefficient and slow growing SMEs, while the UK with low entry barriers has firms that enter at a lower scale than in Italy but grow more rapidly (Thorsten, 2007).

This depicted that, financial constraints are higher in developing countries in general, but SMEs are particularly constrained by gaps in the financial system such as high administrative costs, high collateral requirements and lack of experience within financial intermediaries. Increased access to finance for SMEs can improve economic conditions in developing countries by fostering innovation, macro-economic resilience, and GDP growth (Dalberg, 2011). In this case financial institution has little influence to development of SME's that is why government should review SME's policy to create business environment between financial institutions and SME's.

Table 4.7: Did you start as formal or informal

Legal status of the business at the start	Frequency	Percent
Informal	55	91.7
Formal	5	8.3
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.3.5 Management experience of the Respondents

This is the great factor which influences the financial institutions to grant SME's or not in Morogoro Municipality. The researcher's findings summarized in Table 8 that 46% of SME's owners do not have management experience, 38% of SME's have 3 and above years of experience and 15% of SME's have 1 to 3 years of experience.

These findings show that 46% of SME's owners were at the high risk of not accessing financial support from financial institutions because automatically there are poor record keeping, no constitution, no vision, no employee guidelines and regulations which are used to guide business. The findings show at least SME's owners who fall under the management experience of at least 3 and above years (38%) can access financial support from the financial institutions and those had 1 to 3 years of experience can also access financial support. Therefore, financial institutions have poor influence to the development of SME's because it does very little efforts to improve management of SME's.

Table 4.8: Management experience of the Respondents

Management experience of respondents	Frequenc y	Percent
1- 3 years	9	15.0
3 and above years	23	38.3
does not have any management experience	28	46.7
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.3.6 Number of respondents who received training from financial institutions

Table 4.9 shows that, 40 respondents (66.6%) of the total respondents did not receive any business training from a financial institution while 20 respondents (33.3%) of the SME's received training from the financial institution. This scenario revealed that, most of financial institutions provide training to the giant business owners who can borrow large amount of money with higher interest rates and not SME's.

The study discovered directly that, there is poor influence of financial institutions to the development of SME's because 66.6% of SME's owners fail to attend training due to cost of entrance fee, most of the trainings are conducted at the big cities and it sometimes conducted by using foreign language which was very difficult for SME's to attend. Also, due to being unaware of the courses most of the SMEs fail to attend the training provided by the financial institutions.

Table 4.9: Any member of the company who attended any training provided by financial institution

Any member attended training	Frequency	Percent
Yes	20	33.3
No	40	66.3
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.4 Determining the existing financial institutions in Morogoro Municipality

4.4.1 Number of existing financial institution

In morogoro Municipality there are so many financial institutions which provide financial support to SMEs as shown in Table 4.10. These institutions offered different supports such as loans, entrepreneurship skills, market information and management skills to ensure the development of SMEs of Morogoro Municipality.

Though most of the institutions do not reach the target group (SME's) rather they end up to big customers who invested a lot of capital and shares to their business. In spite of having a lot of financial institutions in Morogoro Municipality, still the study (refer to Table 4.11 below) shows that, only 40% of SMEs used money from financial institutions to start business.

Table 4.10: Existing financial institution in Morogoro Municipality

Name of financial institution	Frequency	Percent
CRDB Bank	1	7.14
NMB Bank	1	7.14
NBC Bank	1	7.14
Postal Bank	1	7.14
KCB Bank	1	7.14
BOA Bank	1	7.14
PRIDE	1	7.14
FINCA	1	7.14
BRAC	1	7.14
EXIM	1	7.14
Barclays	1	7.14
Blue finance	1	7.14
Bayport	1	7.14
Total	15	100

SOURCE: Constructed from primary data (2013)

4.5 Determining the extent to which financial institutions have helped to finance SMEs in Morogoro Municipality

4.5.1 Source of initial financial support of the SME's of the Respondents

Capital is a big factor which has greater influence to development of SME's in Morogoro Municipality. Research findings in Table 4.11 show that, 32 respondents (53.3%) of the total SME's owners started their business by self-own saving, 24 respondents (40%) of SME's have started through borrowing from financial institutions, followed by 2 respondents (3.3%) of the total SME's started by inherit

from the family and lastly 2 respondents (3.3%) of the total SME's has started after being given capital by their friends.

This implies that 53.3% of SME's had failed to access financial support from the financial institutions due to complicated conditions such as lack of collaterals, business license, and opted to save for a long time so as to get enough capital for their business. It shows that only 24 (40%) out of 60 (100%) of SME's can access financial support because they meet conditions of the banks. Also, another risk group as in Table 4.11 is as follows, only 3.3% of SMEs get their capital from friends and others inherit from the family. This shows how much the financial institutions are not influencing development of SMEs in a positive way.

Thus, financial institutions should reduce conditions and allow SMEs to get startup capital for the development of their business. Ayyagari Beck and Demirgüç-Kunt (2006) argue that access to finance is rated as major constraint by around 30% of small and medium enterprises, a similar proportion as a result of economic policy uncertainty and corruption. Further, financing is one of the few characteristics of the business environment that – together with crime and political instability - is linked to firm growth, while other features have at most an indirect effect on firm growth.

Table 4.11: How was your business initially financed

Source of finance at the startup of business	Frequency	Percent
Self-own saving	32	53.3
Inherited from the family	2	3.3
Friends	2	3.3
Borrowing from Micro Finance Institution	24	40.0
Total	60	100

SOURCE: Constructed from primary data (2013)

4.5.2 Amount received by the respondents from microfinance institutions

As shown in Table 4.12, based on the survey, 10 respondents (16.7%) received 1,000,000 to 5,000,000 shillings, 6 respondents (10%) received 10,000,000 to 20,000,000 shillings, 5 respondents (8.3%) received 5,000,000 to 10,000,000 shillings and 3 respondents (5%) received only 100,000 to 500,000 shillings. It implies that 10 respondents (16.7%) received moderated loan from the financial support, the number of the people is too small. Also, this bias shown by financial institutions in the provision of financial support has deteriorated the development of SMEs because as shown in this study only 10% of the total respondents received big loans from the financial institutions while 3 respondents (5%) and 5 SME's owners (8.3%) received very small amount of money. In this case, the influence of financial institution to the development of SMEs is still low.

The results is related to World bank survey (2003) that a crucial element in the development of the SME sector is access to finance, particularly to bank financing, given the relative importance of the banking sector in serving this segment. Firm-level data collected by the World Bank show that access to finance is perceived as one of the main obstacles to doing business (World Bank, various years). A number of studies have shown that financing is a greater obstacle for SMEs than it is for large firms, particularly in the developing world, and that access to finance adversely affects the growth of the SME sector more than that of large companies (Schiffer and Weder, 2001; Beck *et al.*, 2005; Beck *et al.*, 2006). It is, therefore, unsurprising that the international development community has listed SME access to finance as an important policy priority.

Table 4.12: How much received from the Microfinance Institutions

Amount received from MFI's	Frequency	Percent
100,000/= to 500,000/=	3	5.0
1,000,000/= to 5,000,000/=	10	16.7
5,000,000/= to 10,000,000/=	5	8.3

10,000,000/= to 20,000,000/=	6	10.0
Total	24	40.0

SOURCE: Constructed from primary data (2013)

4.5.3 Other support from the financial institutions

In determining the support which financial institutions provide to SMEs the researcher asked respondents about other support they are given by financial institutions apart from funds,, Table 4.13 summarizes as follows: 50 respondents (83.3%) did not receive any support from financial institutions while 10 respondents (16.7%) received training on business management skills.

This influences underdevelopment of SMEs in Morogoro Municipality because training; market information and provision of funds are the key roles which financial institutions should ensure to SME's. Other institutions provide training after seeing that people are not going to borrow from their banks. Many forms, however, are difficult to implement in developing countries. For example Dalbeg (2011) said that countries often have weak accounting standards, and the SMEs have little to no accurate financial statements on their revenues, profits and ability to pay. Furthermore, there is often little to no general market data available on the SME market and specific sub-sectors. This limits the potential for lending based on financial statements or small business credit scores. Therefore, banks primarily engage in relationship-based or other forms of collateral-based lending, rather than cash-flow based lending. Banks tend not to provide financing for working capital to SMEs, which is cited by SMEs as one of the areas of greatest need. The lack of collateral for some borrowers and/or clear recourse legislation (e.g. ability to claim collateral) however, can complicate the possibilities to do collateral based lending (e.g. asset-based, real-estate or equipment lending).

Finally, banks need specific skills to engage in the different forms of SME lending. A recent Dalberg survey showed that the difficulty in establishing credit-worthiness was a key barrier, with 80% of banks stating challenges in this area. Lack of these skills can lead banks to shun the SME market in its entirety, and invest only in high-yielding sovereign government debt, or it can translate into inadequate risk management, leading to lower repayment rates and returns. Some recent initiatives, such as the IFC SME banking guide, are aimed at decreasing this skill gap.

This situation made some SMEs to lack criteria of accessing support because they don't have good record keeping as the key procedures of financial institutions before provision of loan and poor marketing strategy which made some other SMEs to fail to repay debts. Thus, influence of financial institutions to SMEs development is still poor compared to what they required to do to SMEs.

Table 4.13: Other support from financial institutions

Other Support from financial institution	Frequenc y	Percent
Business administration skills	10	16.7
Nothing	50	83.3
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.6 Determining constraints facing SMEs towards financial institution support

4.6.1 Criteria used in accessing support from financial institutions

As shown in Table 4.14, based on the survey, 86.7% of the total respondents said that having title deed of the house you will be able to access loan from financial institutions, 5% of the total respondents said that having a title deed of land, other 5% of the total respondents said that having business license was among the criteria

of accessing support and lastly 3.3% of the total respondents said that being in community groups was the means of accessing support from financial institutions.

In this case, without having the house with the title deed they cannot access financial support from the financial institutions. This is depicted in Table 4.14, whereby 86% percent of SMEs owners fear to access support from financial institutions due complicated conditions of the financial institutions. Recent research also shows the importance of the business environment for firms’ financing constraints and patterns. This limits the potential for lending based on financial statements or small business credit scores. Therefore, banks primarily engage in relationship-based or other forms of collateral-based lending, rather than cash-flow based lending. Banks tend not to provide financing for working capital to SMEs, which is cited by SMEs as one of the areas of greatest need.

According to Beck (2006), lack of collateral for some borrowers and/or clear recourse legislation (e.g. ability to claim collateral) however, can complicate the possibilities to do collateral based lending (e.g. asset-based, real-estate or equipment lending).

Therefore, SMEs owners said that title deed of land as collateral was among the criteria of accessing support which seen as obstacle to many SMEs’ owners who did not own land. Also, being in groups was said to be the criteria but it is mostly used to get small funds, this could not fulfill the needs of the SMEs. Therefore, due to complicated conditions of financial institutions SME’s development is a nightmare.

Table 4.14: Criteria used in accessing financial support from financial institutions

Criteria used to access fund from MFI's	Frequency	Percent
Title deed of the house	52	86.7

Title deed of land	3	5.0
Business license	3	5.0
Be in groups	2	3.3
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.6.3 Other problems facing SME's not to get fund from the financial institution

The researcher was interested in knowing other problems facing SMEs in accessing funds from the financial institutions. As it is represented in Table 4.15, among 60 respondents, 51.6% responded that corruption is among the chronic problem facing officials of financial institutions, 28.3% responded that delay of the loan is also a big problem of financial institutions, while 20% of respondents said disturbances made by financial institutions during the application of the loan was seen to be a big challenge to SMEs.

Research also shows the importance of the business environment for firms' financing constraints and patterns. This limits the potential for lending based on financial statements or small business credit scores. Therefore, banks primarily engage in relationship-based or other forms of collateral-based lending, rather than cash-flow based lending. Banks tend not to provide financing for working capital to SMEs, which is cited by SMEs as one of the areas of greatest need. The lack of collateral for some borrowers and/or clear recourse legislation (e.g. ability to claim collateral) however, can complicate the possibilities to do collateral based lending (e.g. asset-based, real-estate or equipment lending). Beck, Demirgüç-Kunt, Laeven and Maksimovic (2006) show that institutional development, measured very broadly, is the most robust country-characteristic predicting cross-country variation in firms' financing obstacles, even after controlling for cross-country differences in GDP per capita. Firms in countries with higher levels of institutional development report significantly lower financing obstacles than firms in countries with less developed

institutions. The positive effect of financial and institutional development can also be observed in the use of external finance. Better protection of property rights increases external financing of small firms significantly more than it does for large firms, particularly due to the differential impact it has on bank and supplier finance (Beck, Demirgüç-Kunt and Maksimovic, 2004b).

The study found that there are various reasons which made financial institutions to delay to release loans or to disturb SMEs during loan application. Most of the financial institutions indirectly or directly have demanded corruption from the customers/ SME's owners. This leads to vulnerability of some SMEs that were not in position of provide money for the sake of being granted by the institution; they ended up failing to access funds from the financial institution. This shows how the financial institutions have poor influence to SMEs instead of helping them, demanded them to pay before services.

Table 4.15: Other problem facing respondents/SME's in accessing fund from financial institution

Other problems facing SME's	Frequency	Percent
delay of the loan	17	28.30
Corruption	31	51.6
disturbance during the process of loan application	12	20.0
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.6.4 Pressing business problems faced by the Respondents

Results in Table 16 show that 58.3% of the total respondents (SME's owners) had claimed about lack of capital, 25% claimed about competition between themselves and lastly 16.3% claimed on amount of tax collected by the TRA.

This scenario has great influence to under development of the SMEs because capital is seen to be a crucial need of SMEs (58.3%) while financial institutions have not intended to reduce conditions for the SME's development. Also, SMEs (25%) suffered from the problem of competition due to poor quality of goods they produce because of lack of capital. It shows directly that financial institutions have poor influence to the development of SME's.

Table 4.16: Pressing problems of the Respondents

Pressing problems faced by SME's	Frequency	Percent
High tax from TRA	10	16.6
Fund, capital	35	58.3
Competition,	15	25.0
Total	60	100.0

SOURCE: Constructed from primary data (2013)

4.6.5 Respondents areas of business which need more assistance

The result shown in Table 4.17 indicate that, 60% of the total respondents (SME's owners) said capital, loans could be the solution of their problems including improving their products, paying employees, buying raw materials and transport to the market areas. Twenty five per cent (25%) of respondents suggested that, business skills were among the solutions of their problems because they will improve their products, record keeping and market searching. Also, 10% of respondents requested the financial institutions to reduce conditions in accessing loan which hinder much SME's. Lastly, 5% of SMEs requested TRA to reduce tax to SMEs who have limited resources.

The research results are related to survey done by CSO (2008) that suggests that SMEs are constrained their access to formal credit. This is clearly shown that one of

their main reported constraints is lack of capital/equipment and the form of assistance required being better access to loans. In this case financial institutions have many things to do because suggestions provided by the SME's owners fall under the responsibilities of financial institutions. Therefore, the findings show that the contribution of financial institutions is still low and more efforts are needed to improve the development of SME's.

Table 4.17: Respondents' areas of business which need more assistance

Areas of Improvements	Frequency	Percent
Loans/funds/capital	36	60.0
Business skills	15	25.0
Reduce TRA tax	3	5.0
To reduce conditions during fund application	6	10.0
Total	60	100.0

SOURCE: Constructed from primary data (2013)

Focusing on the comparative advantages of different types of financial institutions in using transactions lending technologies versus relationship lending; Transaction lending technologies are primarily based on “hard” quantitative data that may be observed and verified at about the time of the credit origination. This hard information may include, as examples, financial ratios calculated from certified audited financial statements; credit scores assembled from data on the payments histories of the SME and its owner provided by credit bureaus; or information about accounts receivable from transparent, low-risk obligors that may be pledged as collateral by the SME or sold to the financial institution. This information may be relatively easily observed, verified, and transmitted through the communication channels within the financial institution. Individual transactions technologies are

distinguished from one another by the type and source of hard information that is main basis for the underwriting decision.

The relationship lending technology, in contrast, is based significantly on “soft” qualitative information gathered through contact over time with the SME and often with its owner and members of the local community. The soft information may include the character and reliability of the SME’s owner based on direct contact over time by the institution’s loan officer; the payment and receipt history of the SME gathered from the past provision of loans, deposits, or other services to the SME by the institution; or the future prospects of the SME garnered from past communications with SME’s suppliers, customers, or neighbouring businesses. The soft information may often be proprietary to the loan officer and may not be easily observed by others, verified by others, or transmitted to others within the financial institution.

The most common findings in the extant research are that large institutions have comparative advantages in transactions lending to more transparent SMEs based on hard information, while small institutions have comparative advantages in relationship lending to informational opaque SMEs based on soft information (e.g., Berger, Miller, Petersen, Rajan, and Stein forthcoming). A policy implication that might at first blush seem reasonable is that the financial institution structure needs to include a substantial market share for small institutions to meet the demands of informational opaque SMEs, since these SMEs may be constrained in the financing they can obtain through the transactions technologies offered by large institutions.

As shown below, there are a number of different transactions lending technologies based on hard information that are quite heterogeneous. These transactions technologies – financial statement lending, small business credit scoring, asset-based lending, factoring, and trade credit, show that while financial statement lending may be limited to transparent borrowers, the other transactions technologies may be

well-suited to providing credit to informational opaque SMEs. Depending upon the borrower characteristics as well as the financial institution structure and lending infrastructure, one or more of these transactions technologies may be used to supply funding to very opaque SMEs even when relationship lending cannot be effectively employed.

Other financial institution structure and SME access to funding focus on the comparative advantages of foreign versus domestic financial institutions, and state-owned versus privately owned institutions in lending to SMEs. As well, there is considerable research on the effects of financial institution market concentration on the supply of SME credit while advancing understanding of SME finance and associated policy issues, again suffers from the problem that the lending technologies are generally not observed. This makes it difficult to test theories that relate financial institution structure to credit availability for different types of borrowers. Difficulties in observing which lending technologies are employed also complicates policy assessments of which financial institution structure may best address a nation's issues of availability of funds to creditworthy transparent and opaque SMEs.

An additional area of concern regarding SME credit availability is the lending infrastructure of a nation, which defines the rights and flexibility of financial institutions to fund SMEs using the lending technology that best fits the institution and the borrower. This infrastructure includes the commercial and bankruptcy laws that affect creditor rights and their judicial enforcement; the regulation of financial institutions, including restrictions on lending, barriers to entry, and direct state ownership of financial institutions; the information infrastructure, including the accounting standards to which potential borrowers must comply as well as the organizations and rules for sharing information; the taxes that directly affect credit extension; and so forth that provide the economic environment in which financial institutions may lend in a given nation. The lending infrastructure – as well as the

infrastructures that affect equity markets and other parts of the financial system – are quite heterogeneous across both developed and developing nations and may have important effects on the capacity of financial institutions and markets to provide finance in these nations.

The research found out how a nation's lending infrastructure directly affects the extent to which each of the individual lending technologies for SMEs are employed. As examples, weak accounting standards may restrict financial statement lending; restrictions on the sharing of credit information may restrict small business credit scoring; weak commercial laws and enforcement of collateral rights may inhibit asset-based lending; and poorly-designed creditor rights and judicial enforcement of these rights may limit most types of lending. In some cases, restrictions that inhibit the use of one lending technology may encourage the use of others. For instance, poor creditor rights with respect to security interests may promote the use of factoring in which the receivables are sold, rather than pledged as collateral.

Also, findings show how other shortcomings in the lending infrastructure may restrict SME credit availability indirectly by constraining the potential financial institution structure, or the market shares of different types of financial institutions, potentially preventing them from capitalizing on their comparative advantages in the different lending technologies. To illustrate, implicit or explicit government barriers to the entry of foreign financial institutions limit the degree to which foreign institutions may compete to provide credit to SMEs using the technologies in which they excel. Although global data on the use of different lending technologies is quite limited, there is some evidence that the use of these technologies varies significantly across countries. More generally, the significant variance across nations in the technologies used and the finding that lending technologies may be virtually unavailable in some countries demonstrate the potential importance of both the financial institution structures and lending infrastructures. It appears that suboptimal financial institution structures and/or lending infrastructures in many financial

institutions limit the technologies available for funding SMEs, and thereby likely significantly reduce credit availability for SMEs.

The financial institution structure may affect the credit availability for both transparent and opaque SMEs because different types of financial institutions have comparative advantages in different lending technologies. The lending infrastructure may directly affect SME access to credit through restricting the lending technologies that can be legally and profitably employed, and may indirectly affect SME credit supplies through constraining the potential financial institution structure, limiting the abilities of different types of institutions to use their comparative advantages in employing different lending technologies.

However, this research has not come to consensus regarding exactly which dimensions of the financial system matter most. Focusing on the parts of the financial system that are most relevant to SME finance, the research concentrates on the private debt markets that provide external finance to SMEs, and excludes discussions of: the public equity and debt markets, which are generally beyond the reach of SMEs; the private equity markets and the technologies they use (venture capital and angel finance), since access to these markets is typically limited to a small subset of SMEs in specific industries and the funding from internal or nearly internal sources like the entrepreneur, family, and friends. The finance-growth nexus as it relates to SMEs also depends on the link between SME activity and economic growth, but we exclude this topic in the interest of brevity and to focus on the financing of SMEs.

Focusing on financial institution structure and SME lending, research found out some of the structures related to the comparative advantages of large versus small financial institutions, foreign-owned versus domestically-owned institutions, and state-owned versus privately-owned institutions in lending to SMEs. We also review the literature on the effects of bank market concentration on the supply of SME

credit. These show how research generally is able to differentiate at most between transactions lending and relationship lending. Given that transactions lending technologies may be used to fund opaque.

The link between SME activity and economic growth is important for research purposes because of the relatively large share of the SME sector in most developing nations like Tanzania and because of the substantial international resources that have been channelled into the SME sectors of these nations. The findings of this research may be potentially good to researchers and policy makers regarding the financial institution structure that may best supply credit to transparent and opaque SMEs.

Focusing on the lending infrastructures of nations and how they affect the financing of SMEs. Findings describe how the information infrastructure, commercial laws, judicial system, bankruptcy system, the tax and regulatory environments may directly affect SME lending. Also, discusses the indirect effects of lending infrastructure on SME credit through regulatory restrictions on the financial institution structure. Also it provides review of some of the relatively limited research literature on lending infrastructure and SMEs.

Focusing on the lending technologies used to finance SMEs, the research describes the transactions lending technologies (financial statement lending, small business credit scoring, asset-based lending, factoring, and trade credit) and the relationship lending technology. For each technology, the report discusses the primary source of information used in underwriting the credit and the extent to which the technology is used to lend to transparent and opaque SMEs. Also, it thrashes out the financial institution structures and lending infrastructures that are needed for the technology to be legally and profitably employed to lend to these SMEs. It also discusses which financial institutions have comparative advantages in each technology, and which commercial/bankruptcy laws, judicial system, financial institution regulation, information infrastructure, or tax policies may encourage or discourage the use of

each technology. Findings point out how policies that affect the use of a technology also have consequences for the availability of funding for creditworthy SMEs that might otherwise receive funding through that technology.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

Basing on research finding it can be concluded that financial institutions have an opportunity to know and learn their SME customers well, also their needs and wants and in trying to offer credit service as per customer fulfillment. Also, financial institutions should find out better ways so that SME's development can be effectively carried out. Furthermore, financial institutions provide credit services to SME's customers basing on the customer opinion and views; moreover, they have to improve as much as they can so as to offer superior and more developed SME's in Tanzania. The financial institutions management should make sure they solve problems customers face and work hard on satisfying the needs and want of their customers.

Relevance of these findings to overall influence of financial institutions policy context is not straight forward and the extensive literature review regarding the overall factors and its determinants to SME's development. As I did in the background, it was intended for the purpose of showing the influence of financial institutions to development of SME's as an important research issue. My intention was to elevate the influence of financial institutions to SME's because there is every possibility that education level of SME's owners, nature of business, conditions made by the financial institutions in accessing support, and existing financial institutions criteria will continue to influence SME's development.

In Morogoro Municipality, education level, management experience, collaterals needed by existing financial institutions play a significance role in determining development of SME's in terms of capital, market information and business skills. Economic variables like conditions made by the financial institutions such as title deeds of houses and land, business license, and management experience depict poor influence of financial institutions to development of SME's. I conclude that factors like high interest rate posed by the MFI's, high tax from TRA, corruption demanded by the financial institutions officials during loans application concluded to be the factors which perpetuated by MFI's to slow down development of SME's. I also concluded that the influence of financial institutions is very poor to development of SME's due to restricted conditions.

Ministry of Industry and Trade should conduct a broad research agenda so as to better understand SMEs' financing needs in developing and emerging economies. First, it is important to better understand SME lending practices by financial institutions and identify best practices. Even more important, however, is it to understand how these practices depend on the business environment in which the financial institutions operate. Efforts are under way using bank-level surveys and interviews. Second, while we have focused mainly on the banking system – driven by the observation that banks still constitute the largest component of financial systems in the financial system of most developing and emerging markets – the role of non-bank financial institutions and financial markets, both on the debt and the equity side has to be explored in more detail. Third, the role of technology in expanding SMEs' access to financial services has been little explored. While the introduction of credit scoring has been shown to expand SME lending in the U.S., it is not clear whether this technology can be easily applied to developing countries. By enabling more cost-effective consumer lending, technological advances such as credit scoring or alternative delivery channels such as electronic or mobile finance, might push lenders out of the SME lending market, thus even exacerbating SMEs' financing constraints. Fourth, case studies on market-friendly activist government

interventions should be undertaken, but a more rigorous impact evaluation is necessary, such as has been started for microfinance institutions. Government should ensure better impact of the institutional structure, funding and pricing of partial credit guarantee schemes on SMEs’.

5.2 Recommendations

To address the challenges faced by financial institutions in promoting enterprise culture, the researcher recommends the following measures to be taken: Financial institutions should start offering credit management training to SMEs in order to help them to repay loans in time, and thus help to promote enterprise culture among SMEs. The government should support MFIs which deal with SMEs because in doing so, MFIs will be in a better position to assist more SMEs and help to develop more SMEs, and promote enterprise culture in the process.

Financial institutions and other MFI should conduct awareness campaigns among SMEs which will help them to become more successful and in the process encourage more people to become entrepreneurs and thus promote enterprise culture

Finally, financial institutions should review their terms and conditions on credit in order to enable SME’s by considering the condition of borrowers based on economically and socially on security/collateral demanded. Therefore, the security on loan can be varied according to the economic and social aspects pertaining to each borrower and this can improve customer service on credit. Financial institutions should pay visit their customers and seek ideas from them if they are satisfied with the services provided to them, through that the bank will build more trust, confidence to customers.

This study has clearly demonstrated that the excess underdevelopment of SME’s is due to poor influence of micro finance institutions, which have restricted conditions which hinder SME’s to access capital, market information, business skills.

5.3 Suggestions for further studies

This has is very significant in as far as efforts to promote the performance and development of SMEs in Tanzania is concerned. It has explored various factors that influence the behaviour of financial institutions in supporting the development of SMEs and the criteria that influence their decisions. However, the researcher cannot claim that this study has been exhaustive as it just focused on few areas only and was conducted in Morogoro Municipal Council. The researcher believes that more aspects need to be investigated and more areas also are supposed to be involved. Therefore, the following areas need further research:

- Exploring the role of non-financial institutions and financial markets, both on the debt and equity side. This is because this study focused mainly on the banking system – driven by the observation that banks still constitute the largest component of financial systems in the financial system of most developing and emerging markets.
- Also, the role of technology in expanding SMEs' access to financial services needs to be explored in-depth
- Lastly, the study with a topic similar to this this study should be carried out in other municipalities or regions in Tanzania so as to get a comprehensive picture of the extent of the problem. With a comprehensive picture regarding the problem, effective ways can be devised in enhancing the provision of financial support to SMEs for fast development and growth..

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APPENDICES

APPENDIX 1: RESPONDENT’S QUESTIONNAIRE

Topic: Influence of financial institution to the development of Small and Medium Entrepreneurs (SME’s) in Tanzania.

INTERVIEW NUMBER.....

NAME OF INTERVIEWER.....

NAME OF RESPONDENT.....DISRICT.....

DIVISION.....WARD.....VILLAGE/STREA
T.....

DATE OF THE INTERVIEW-----

SECTION I: BASIC INFORMATION

1. What is your age group?
 - (1) 0—20 years
 - (2) 21—30 years
 - (3) 31—40 years ()
 - (4) 41—50 years
 - (5) Over 51 years
2. Sex (1) Female (2) Male ()

3. What is your Level of education?

- (1) Primary education
- (2) Secondary education (Lower level/Higher level) ()
- (3) Diploma level
- (4) Higher learning education
- (5) Not yet educated

4. What other qualifications have you obtained in work? (It should not be related to your professional)

	Qualification	Date achieved
A		
b.		
c.		

SECTION II: DETAILS ON NATURE OF BUSINESS

5. What is the nature of the business at the start?

- (1) Products oriented ()
- (2) Service oriented
 - (a) If the answer is product, mention them -----

 - (b) If the is service mention-----

6. How old are you in this business?

- (1) Below 1 year (2) Between 1-5 years (3) Above 5 years ()

7. Employee at the start of the business

- (1) 1 - 4

- (2) 5-50
- (3) 51-100 ()
- (4) Over 100

8. How much was your startup capital in Tshs.

- (1) Below 100,000/= (2) 101,000 /= to 500,000/=
- (2) 501,000/= to 1,000,000/= ()
- (3) Over 1,000,000/=

9. Did you start as formal or informal? (1)Yes (2) No ()

10. Is your Business registered? (1) Yes (2) No ()

11. Is your business has constitution, mission and vision, Strategies and work plan?

- (1)All (2) not all (3) If either of the above, (cycle the answer)

12. What is the legal status of your business?

- (1)Sole proprietorship
- (2)Partnership ()
- (3)Limited coy
- (4)Others (please specify).....

13. Did you have any Management experience in your job or previous job?

- (1) Yes (2) No ()

14. Working backward from now what is your Management experience including the current post?

	Position	Time frame
a.		
b.		
c.		
d.		

15. Have you had any formal training on business skills or Entrepreneurship since you started your business? **(For sole proprietorship)**

- (1) Yes (2) No ()

If yes, please specify-----

--

16. Have you/anyone in your company received training in any business skills?

- (1) Yes (2) No ()

17. If not, what are the reasons for this failure? **(Tick the appropriate answer)**

- (1) Course too expensive
- (2) Unaware of the courses
- (3) Found not necessary
- (4) No interest

SECTION III: SUPPORT FROM FINANCIAL INSTITUTION

18. How was your business initially financed?

- (1) Self - own savings
- (2) Inherited from family ()
- (3) Friends
- (4) Borrowing from Micro Finance institution
- (4) Government sources

19. If the answer is borrowing from micro finance institutions, how the loan repayment affected your income?

- (1) Increased
- (2) Remained the same ()
- (3) Decreased

20. How much did you received from the financial institutions?

Mention the institution.....
.....
.....

21. What other support received from financial institution
.....
.....
.....

22. What is the trend of your investments after being granted loan in the last 5 years?

- (1).Increased
- (2) Remained the same (3) Decreased ()

23. Which criteria are used in accessing loan from financial institution?

.....
.....
.....
.....

SECTION IV: LIMITATION OF ACCESSING SUPPORT FROM FINANCIAL INSTITUTIONS

24. What are the other problems facing in accessing support from financial institutions?

.....
.....
...

25. What are the pressing problems of your business in order of importance?

26. In which area would your business require more assistance to grow in the foreseeable future?

THANKS FOR YOUR COOPERATION

APPENDIX 2 RESEARCH TIMEFRAME

Schedule of activities	2012					2013									
	August	September	October	November	December	January	February	March	April	May	June	July	August	September	October

Proposal development	■	■	■	■	■	■	■	■								
Pre-testing of questionnaires									■							
Survey data collection										■	■					
Data coding, cleaning and editing												■				
Data analysis																
Dissertation report writing and presentation													■	■		
Submission of final dissertation																■

APPENDEX 3: BUDGET

Description	Items	Amounts (Tshs)
Proposal Development	Typing and printing	540,000

Data Collection	Typing and printing of questionnaire, transport and data collection materials	1,000,000
Questionnaire pre-testing		860,000
Sub-total		2,400,000
Data analysis and first draft report production		800,000
Data analysis and final draft report production		800,000
Sub-total		1,600,000
GRAND TOTAL		4,000,000
Source of fund: PRIVATE		