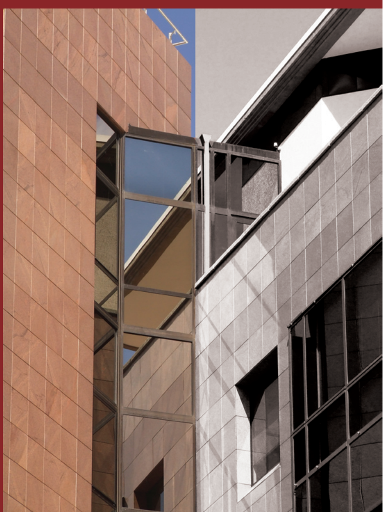
Bank of Namibia



12th ANNUAL SYMPOSIUM 2010

SME DEVELOPMENT IN NAMIBIA

Bank of Namibia

12th Annual Symposium Publication 2010

SME DEVELOPMENT IN NAMIBIA

Edited by the Research Department

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Preface

The 12th Annual Symposium of the Bank of Namibia was held on the 29th of September 2010 at the Safari Conference Centre in Windhoek. The theme of the symposium was “SME Development in Namibia”.

The role that SMEs play in any economy is well-documented. It is also a well-known fact that SMEs all over the world face unique challenges, which hamper their development and realisation of their full potential. Many of the challenges faced by SMEs globally also apply to Namibian SMEs. It is against that background that the Bank of Namibia decided to initiate debate and dialogue on the subject through its 12th Annual Symposium.

In order to contribute to the debate and to share ideas, international speakers and local discussants were invited, based on their expertise and experience regarding the subject matter. The speakers were Mr. Neil Ramsden of International Finance Corporation based in New Zealand; Dr. Rob Smorfitt, an independent consultant and entrepreneur from South Africa and Dr. Christoph Stork from Research ICT Africa based in Cape Town, South Africa. In order to get local insight and perspective, two Namibian discussants were invited; Mr. David Nuyoma of the Development Bank of Namibia as well as Mr. Herbert Jauch, an independent researcher and educator. All speakers and discussants’ papers are published herein.

Overview

The Governor of the Bank of Namibia, Mr. Ipumbu Shiimi, in his welcoming remarks reiterated the importance of SMEs in the economy. According to Mr. Shiimi, SMEs have the potential to create employment and contribute to economic growth of a country. This holds true for both developed and developing countries. Mr. Shiimi further acknowledged the efforts of the government in promoting SMEs in Namibia. Some of the efforts of government in SME promotion include the existence of the dedicated department which deals with SME issues in the Ministry of Trade and Industry, the establishment of various physical infrastructure to provide an enabling environment for production and trading by the SMEs, as well as Government efforts to provide financing to the SME sector. Despite the abovementioned efforts, Mr. Shiimi concluded by saying that the challenges still remain, especially in terms of SME financing; and therefore there is a need to find a workable solution to that challenge, which will enable more SMEs to grow and ultimately contribute to economic growth and poverty reduction.

There were three papers presented on the theme by international speakers. Dr. Christoph Stork presented the first paper entitled: “The state of SME development in Namibia”. According to the paper, the SME contribution to GDP in Namibia was about 12% and the employment share was about 20% in 2003 and 2004. The presenter bemoaned the lack of current statistics on the SME sector, and pointed out that the above-mentioned figures might have changed since the last surveys in those years. Notably the paper distinguished between formal and informal SMEs in Namibia. According to Dr. Stork, the informal sector is different from the formal sector in that in the informal sector laws and regulations are only been partly followed, if at all, and employees usually do not have any benefits such as leave, social security and medical aid. The paper also focused on the challenge of SME financing. According to the paper, due to fact that most SMEs in Namibia cannot have access to the formal banking system to get funding, there is need to adopt a different approach which will involve making use of mobile technology to allow informal businesses to get access to finance.

The second paper entitled “The role of SMEs in employment creation and economic growth: lessons from other countries” was presented by Mr. Neil Ramsden. The paper outlined the contribution of SMEs to GDP and employment in both developed and developing countries. According to the paper, SMEs account for a significant share of employment and GDP around the world, especially when taking into account the informal sector. In developed countries, SMEs employ around 67 percent of formal sector workers, while in developing countries, this number is lower at around 45 percent. Similarly, SMEs contribute a sizeable share to GDP, 49 percent on average in high income countries and 24 percent on average in low income countries. Furthermore, the paper highlighted barriers to SMEs growth; these include Business regulation (how easy it is to open and close a business and obtain the necessary operating permits and licenses for example); Infrastructure (unpredictable electricity supply, logistics of getting produce to market); Corruption; Access to finance (across the full range of financial services, not just credit); Management capacity (having the skills across a wide range of disciplines, many of which are specialized/technical). The paper concluded that there is no one ‘magic bullet’ that will ensure growth in a country’s SME sector, however in an effort to ensure SME growth and development there is a need for government and the private sector to come together to address SME needs, especially the financing needs that so often suppress the creativity and innovation characteristically seen amongst SMEs from around the world.

The second paper was discussed by Mr. Herbert Jauch. In his presentation, Mr. Jauch pointed out that the current definition of SME in Namibia should be reviewed in light of international definitions on the SME sector in order to allow comparisons. The discussant further agreed with the conclusion of Mr. Ramsden that the SME sector has the potential to contribute to more employment in Namibia, provided that the key challenges as identified by Mr. Ramsden are addressed. Mr. Jauch concluded by asserting that if SMEs receive the necessary support and protection, they have potential to create more employment in Namibia, compared to employment emanating from foreign direct investment.

The final paper was entitled “SME financing: strategies for Namibia” and was presented by Dr. Rob Smorfitt. The paper identified market failure as the primary reason for government intervention in the funding market for SMEs. According to the paper, the critical issue is to design interventions that will result in lower cost to government, while it offer maximum benefits to the SMEs. Dr Smorfitt was of the view that funding should not be provided in isolation but should be linked to other interventions that will ensure that SMEs are sustainable and profitable. Skills development is imperative if the aforementioned is to be achieved.

The discussant of Dr. Smorfitt’s paper was Mr. David Nuyoma, who agreed with the main points raised by Dr. Smorfitt and further outlined the views and experience of the Development Bank of Namibia with regard to SME financing. According to Mr. Nuyoma, there are three factors that hamper SME funding, namely demand-side constraints, supply-side constraints and lending infrastructure, policy and institutional constraints. If those constraints are adequately addressed, more SMEs in Namibia would be able to get access to funding.

Welcoming remarks

by
Mr. Ipumbu Shiimi,
Governor of the Bank of Namibia,
at the 12th Annual Symposium on: SME development in Namibia

Director of Ceremony

Distinguished invited guests

Distinguished Speakers and Discussants

SME Owners and Service Providers

Members of the Media

Ladies and Gentlemen

Seeing you all here today gives me a reason to express a sense of gratitude. Many of you have graced this annual event for the past eleven years with your presence and contribution. A warm welcome to you all!

Today marks the 12th year that the Bank of Namibia is hosting this event. As it has been explained in the previous symposia, the purpose of the Annual Symposium is to stimulate debates and policy dialogues on relevant economic issues affecting our country. As such, we consider this event to be one of the significant processes aimed at contributing to the development efforts of Namibia. Over the past years, I believe that we have collectively achieved this objective. For this we are grateful.

As a tradition, we thought of tapping into the expertise of our colleagues from within and outside the SADC region. Join me in extending a special welcome to our guests. We wish them an enjoyable stay in Namibia. Hopefully, they will find sometime to explore the beauty of Namibia as tourists, if that is not possible now; we kindly invite them to come back. Let me also extend a warm welcome to our local speakers. Thank you for honouring our invitation.

Ladies and Gentlemen, even though we have made considerable strides in the economic policy sphere, the three related daunting challenges of poverty, unemployment and income inequality continue to haunt us as a country. Therefore, as economic planners and thinkers, we are called to further action aimed at facing these challenges head on. It is in this light that the theme for this year's Annual

Symposium is "SME Development in Namibia". The role which SMEs play within an economy cannot be over emphasised. This is because SMEs have the potential to create employment and contribute to economic growth of a country. This realisation is equally true for both developed and developing countries. The importance of the SME sector within the economy has been amplified by the current global financial crisis. Acknowledging the role of SMEs, the American law makers recently passed a bill to the tune of USD30 billion aimed at encouraging local banks to lend to small businesses, as a way to further grow their economy out of the crisis. Equally, countries with thriving SME sectors appeared more resilient during the economic crisis. For example, countries such as India registered economic growth close to a double digit, even at the height of the crisis. It is reported that India's SME sector contributes about 50 per cent to India's total exports.

Director of Ceremony

The Namibian Government has recognised and acknowledged the importance of the SME sector within the economy. As one of the ways towards achieving the ideals of our National Vision, Namibia aspires to have a flourishing SME sector by the year 2030. The importance placed on this sector therefore, is evidenced by the special attention and efforts directed to this sector. To this effect we commend various efforts by the Government of Namibia, particularly the Ministry of Trade and Industry towards developing the sector. These include amongst others, the existence of the dedicated department which deals with SME issues in the Ministry of Trade and Industry, the establishment of various physical infrastructure to provide an enabling environment for production and trading by the SMEs, as well as Government efforts to provide financing to this sector. Initiatives by the private sector as well as non-governmental organisations (NGOs) aimed at assisting SMEs are also acknowledged. These efforts, both by the Government, private and NGOs, Ladies and Gentlemen, ought to be applauded.

Despite these efforts however, there is still room to further develop our SME sector for it to contribute meaningfully to the economy. There are several challenges, which are currently hampering this sector to flourish. Access to finance has been identified as one of the key obstacles. Additionally, limited business support services and entrepreneurial skills also pose a challenge. These challenges therefore suggest that as a country, we still need to do more, and or perhaps more players need to be involved in the development of SMEs. Namibia equally needs to identify the appropriate financing model for SMEs. For a country with widespread poverty and a high level of unemployment, we are compelled to seek solutions to these challenges. It is believed that finding solutions to these challenges will not only broaden our economic activity base, but also address the issues of poverty, unemployment and income inequality. I hope by the end of today's deliberations, we shall find a workable consensus on these very important issues.

Director of Ceremony

Our gathering here today should therefore be seen as a sacred call, to deliberate on these very important issues aimed at complementing the efforts by the Government of building a thriving SME sector. I do believe that with the unwavering commitment from all role players, we can develop a flourishing SME sector as one of the important milestones towards the ideals and promises of prosperity and employment creation set out in Vision 2030. Ladies and Gentlemen, let me welcome all of you once again to this year's Symposium, and please enjoy the rest of the day.

I thank you for your attention!

The state of SME development in Namibia

by
Dr. Christoph Stork,
Senior Researcher, Research ICT Africa (RIA)

Abstract

A recent business climate survey by the Namibian Chamber of Commerce and Industry (NCCI) shows that businesses are optimistic but that they are far more prepared to invest than they are to employ. A reason for that could be Namibia's restrictive labour laws that make it a risk for a business to employ someone. Generally, informal businesses are more optimistic than formal businesses. Informal businesses are also less pessimistic when it comes to employment compared to their formal counter parts.

Access to and cost of capital remain the biggest obstacles to business performance and further investment. Family and friends remain the main source for business loans in the informal and/or micro business sector. Serving the informal sector profitably and sustainably requires a radically different approach. Mobile money transfers have the potential to provide an urgently needed breakthrough. Banks need to get back to basics and focus on making money through financial intermediation rather than through transaction fees.

Policy-makers and regulators need to ensure that evolving systems serve the broader objectives of economic growth and development as well as to protect consumer interests, while creating an environment that encourages and rewards innovation.

1. Introduction

The private sector is the engine for sustainable economic growth. The role of the public sector is to create an enabling environment in which entrepreneurs can explore opportunities and thus increase productivity, contribute to economic growth and create jobs. In his book titled "A Strategy for Development", Nicholas Stern (2002) identifies two pillars which form the foundation of any sustainable economic development strategy:
- Building an investment climate that facilitates investment and growth; and
- Empowering poor people to participate in that growth.

Stern (2002) points out that the private sector is not only the main engine for economic growth, but it is also the principle provider of economic activity for poor people, either employment or self-employment. He compares the improvement of the business climate, with the improvement of the symbiotic relationship between sowing and reaping. The ASCCI White Paper of the Association of SADC Chambers of Commerce and Industry from 2001 (ASCCI 2001) refers to investor confidence in this context: “If we want investment in the region, whether from national sources or from non-national ones, we have to establish a climate of investor confidence.” Stern (2002) classifies aspects of public and private activities that influence the investment climate, into three broad categories, notably:

- Activities that address macroeconomic stability and openness of the economy: Monetary policy that aims at price stability and trade agreement that remove trade barriers;
- Good governance and strong institutions: This includes the effectiveness of the government in providing sound regulatory structures for the promotion of a competitive private sector and effective provision of public services. It includes strong financial institutions, the rule of law and the enforcement thereof; and
- Quality of infrastructure, including public utilities such as water, electricity and transport/telecommunications.

The conditions under which the private sector flourishes can be described through general principles (Stern, 2002):

- Firstly, the easier it is to start a business or close a business, the easier and less costly it will be to test potential opportunities;
- Secondly, the lower the costs are for doing business, the more investment opportunities will be profitable and hence realised. Costs of doing business include taxes, cost of capital, costs of contract enforcement, indirect costs of crime/corruption, opportunity and hidden costs. Waiting for a telephone line to be installed or an import permit, translates into costs for businesses; and
- Thirdly, competition leads to productivity increases and lower costs in the long run.

Governments have several intervention points at their disposal to improve the investment climate:

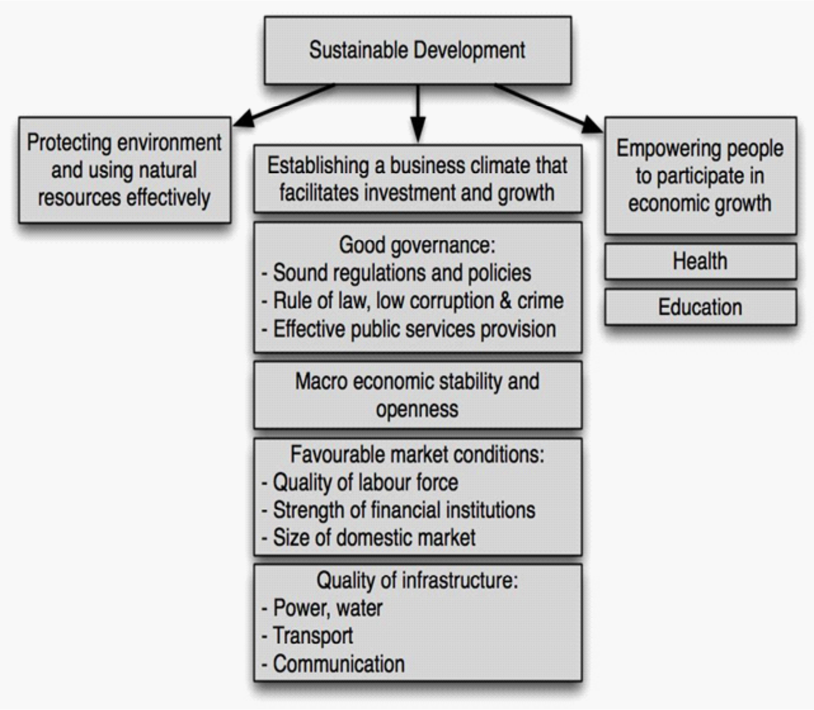
- Removal of barriers to competition by lowering regulatory requirements and facilitate access to land and capital;
- Reduce risks of running a business by safeguarding a stable economic and political environment; and
- Contain the costs of doing business by curbing corruption in public institutions and improving the service delivery of government services.

Addressing these issues requires an intensive dialogue between governments and the private sector. Business climate surveys (BCS) have proven to be useful tools for public private sector dialogue by providing up-to-date information about business performance, investment and employment plans and the obstacles faced by businesses. Moreover, regularly conducted BCS can be used to monitor the success of governmental reform programs.

The paper makes use of the following data:

- e-Access & Usage SME survey, conducted in 2005/6 by ResearchICT Africa in 15 African Countries,
- Namibian Business and Investment Climate Survey (namBic) conducted by the Institute for Public Policy Research (IPPR), and the NCCI in 2009,
- Doing Business in 2010, survey conducted by the Worldbank, and
- World Economic Forum, Global Competitiveness Index2009/2010.

Figure1: Link between sustainable development and business climate



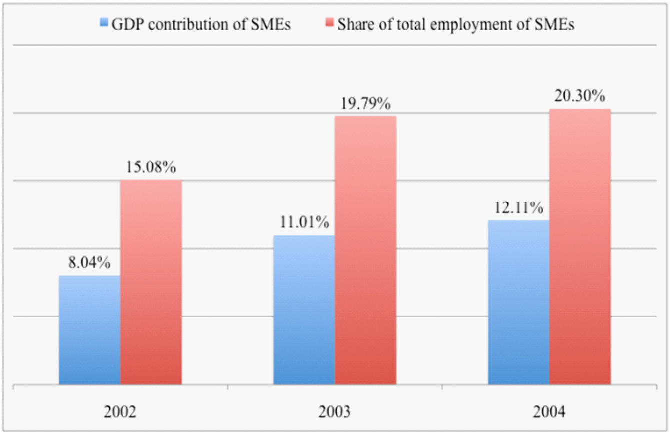
2. SME contribution to GDP and employment

Nationally representative business surveys cannot be conducted without a reliable sample frame which only a business census can provide. Reliable estimates of the contribution of SMEs to GDP and employment can only be obtained from nationally representative business surveys.

Three partial SME base-line surveys were conducted by the Ministry of Trade and Industry (MTI) in Ohangwena, Omusati, Oshana, and Oshikoto in 1998, Erongo and Otjozondjupa in 1999 and Khomas in 2000 (Republic of Namibia 1998, 1999, 2000). The first full business census has been conducted in 2009. The Technical Committee overseeing the process comprised of the National Planning Commission (NPC), the Ministry of Labour, the Bank of Namibia, the Namibian Chamber of Commerce and Industry (NCCI) and was spearheaded by the MTI Directorate of Industrial Development. The results of the census are expected to be released during 2010 still. The census will provide a unique sample-frame from which a nationally representative sample can be drawn. Representative sampling can be done by businesses size, sector, region and other classifications, providing a valuable tool to generate intelligence for evidence-based policy making. The census comprises the formal and informal sector, down to informal operators, who traditionally would not be counted as enterprises (see Esselaar & Stork 2006).

The last attempts to measure the GDP and employment contribution of SMEs to Namibia's economy were made by Stork et al (2004) and Arnold et al (2005). The GDP contribution according to these studies was about 12% and the employment share about 20% in 2003 and 2004. The absence of a sample frame and the ability to conduct nationally representative business surveys means that these figures are only indicative.

Figure 2: GDP and Employment contribution of SMEs:



Source: Stork et al 2004, Arnold et al 2005

3. Namibia's business climate

Several survey frameworks assess the business climate in Namibia. Among them are the Doing Business Project of the World Bank, the Global Competitive Index by the World Economic Forum and business climate surveys conducted for the NCCI by IPPR, NEPRU or the Survey Warehouse.

The Global Competitiveness index is based on perceptions of business leaders and hard infrastructure data and is categorised into 12 pillars for competitiveness which are grouped into basic requirements, efficiency enhancers and innovation and sophistication factors. Table 1 displays the results for Namibia for 2009/2010. Namibia ranked 74 out of 133 countries that participated in terms of global competitiveness; that is competitiveness compared to other countries. This implies that there are 73 countries among the 133 participating countries that are more competitive than Namibia, among the South Africa and Botswana which ranked 45 and 66. Table 1 also highlights Namibia's strength and weaknesses in international comparison. Namibia scores well for institutions (37) and infrastructure (32) and financial market sophistication (31).

Table 1: Global Competitiveness Index

	2009-2010
Global Competitiveness Index Ranking	74
Subindex A: Basic requirements	**53**
1st pillar: Institutions	37
2nd pillar: Infrastructure	32
3rd pillar: Macroeconomic stability	66
4th pillar: Health and primary education	109
Subindex B: Efficiency enhancers	**90**
5th pillar: Higher education and training	110
6th pillar: Goods market efficiency	77
7th pillar: Labor market efficiency	57
8th pillar: Financial market sophistication	31
9th pillar: Technological readiness	86
10th pillar: Market size	113
Subindex C: Innovation and sophistication factors	**91**
11th pillar: Business sophistication	86
12th pillar: Innovation	103

Source: http://www.weforum.org

Namibia compares very poorly in terms of health care and primary education (109), Higher education and training (110) and innovation (103).Health care and education can and needs to be addressed at National level. A healthy and skilled work force would not not only increase Namibia's international competitiveness but also increase the wellbeing of Namibians.

Macro economic stability (66) would need to be addressed within the Common Monetary Area (CMA), and market size (113) on SADC level. Free trade area membership is the only way Namibia could overcome its limited market size.
Table 2 details the main categories for doing business in Namibia, Botswana, South

Africa and the average for the OECD. The doing business projects is not based on perceptions but on number of procedures, time and cost to comply with regulatory requirements and laws. In Botswana and South Africa it is easier to do business, start a business, register property and pay taxes. Also investor protection is better in Botswana and South Africa. Namibia scores better in terms of getting credit, dealing with construction permits and enforcing contracts compared to Botswana.

The purpose of this comparison is not a comparison between neighbouring countries but rather to identify best practice and to learn from another. Why is it quicker and cheaper to start a business in Botswana than in Namibia? Generally any improvement in the business climate will benefit businesses and therefore Namibia in terms of economic growth and employment.

The SME sector in Namibia has two faces however, a formal and an informal one. Being small or operating in the informal sector has advantages and disadvantages. The informal sector is different from the formal sector in that laws and regulations are only been partly followed if at all. Employees usually do not have an employment contract, they have no leave, no social security, no medical aid and are usually family members or friends. Informal businesses usually do not pay taxes, keep receipts or conduct bookkeeping.

Table 2: Doing Business in 2010

	OECD	Namibia	Botswana	South Africa
Ease of Doing Business Rank	14	66	45	34
Starting a Business	14	123	83	67
Dealing with Construction Permits	14	38	123	52
Employing Workers	14	43	71	102
Registering Property	14	134	44	90
Getting Credit	12	15	43	2
Protecting Investors	13	73	41	10
Paying Taxes	14	97	18	23
Trading Across Borders	14	151	150	148
Enforcing Contracts	14	41	79	85
Closing a Business	14	55	27	76

Source: www.doingbusiness.org

Esselaar & Stork (2006) distinguish between informal operators, informal businesses and formal businesses. The International Labour Organization (ILO, 2004) distinguishes three types of enterprise models: pre-entrepreneurial activities; micro-enterprises; and small enterprises. Pre-entrepreneurial activities or informal operators are strictly speaking not businesses but activities of individuals.

Table 3: SME Definitions

Types	Characteristic (no hard rules!)
Informal Operator/ Survivalist	• no employees • no distinction between business and personal finances • does not keep records • does not pay taxes • is not registered with any authority • engages in business activities to pay for daily expenses
Informal Micro or Small Business	• less than 10 employees • no distinction between business and personal finances • might not keep records • might not pay taxes • might not be registered with any authority • has physical address and contact details
Formal Micro or Small Business	•between 10 and 49 employees • keeps records • has separate bank account • pays taxes • is registered with all required authorities • has physical address and contact details

Source: Esselaar & Stork 2006

The informal sector in developed countries is seen as negative, linked to tax evasion and workers exploitation. In Africa the perspective needs to be different. The size of the informal sector is directly linked to the conduciveness of the formal business environment. The easier it is to run a formal business the smaller the informal sector will become. The informal sector is where those that cannot find formal employment struggle to make a living. The challenge for African countries is not to regulate the informal economy but to let it evolve into formal business activities. Increasing the conduciveness of the formal business environment and increasing health care and education are the only ways of achieving that.

The NCCI (2009) business climate survey asked businesses to rate the ease of complying with regulatory requirements using a five value Likert scale. Table 5 displays average values. A -2 represents very difficult and +2 very easy to comply with a specific requirement. The general results confirm intuition, i.e. informal firms find it more difficult to comply with regulatory requirements compared to larger ones.

Business climate and confidence is expressed through investment and employment plans as well as an evaluation of the conduciveness of the current business climate. Investments and employment plans in particular are votes of confidence into the prospects of a business. Investments require time to amortise and employment means that a business enters into a medium term contract with a new employee. Both would not be undertaken if a business is expecting stagnation or decline in its businesses activities.

Table 4: Average ratings for ease of doing business by formality of business

	Informal	Formal
Ease of the process of establishing a business	-0.58 (difficult)	-0.04(neutral)
Ease of obtaining industry-specific permits	-0.19 (neutral)	-0.05(neutral)
Ease of obtaining land for the business	-1.02(difficult)	-0.28(neutral)
Ease of registering a business	0.01 (neutral)	0.39 (neutral)
Ease of property registration	-0.16 (neutral)	0.2 (neutral)
Ease of enforcement of contracts and property rights	-0.32 (neutral)	0.08 (neutral)
Ease of the process of obtaining work permits for foreign nationals	-0.96 (difficult)	-1.21 (difficult)

Table 5 shows the results for investment and employment plans separated by formality and business size. The average intent for making investments in 2009 was positive, in particular for micro enterprises and the informal sector. 46% stated they will not employ more in 2009. Formal businesses were also slightly more pessimistic compared to informal ones. Interestingly businesses are far more prepared to invest than they are to employ. A reason for this could be Namibia's restrictive labour laws that make it a risk for a formal business to employ someone.

Table 5: Namibian Business Climate in 2009

Category	Intent to investments in business	Intent to employs more	General economic condition
All	0.28 (slightly optimistic)	-0.76 (pessimistic)	0.02 (neutral)
0 to 5	0.41 (slightly optimistic)	-0.85 (pessimistic)	-0.11 (neutral
6 to 25	0 (neutral)	-0.63 (pessimistic)	0.22 (neutral)
26+	0.23 (slightly optimistic)	-0.58 (pessimistic)	0.31 (neutral
Formal	0.02 (neutral)	-0.88 (pessimistic)	-0.08 (neutral)
Informal	0.54 (optimistic)	-0.65 (pessimistic)	0.13 (neutral)

Source: NCCI 2010

The dominant reason for not making significant investments in 2009 was a lack of financial resources with 53% of those companies indicating that they will not invest in 2009. For 64% of informal and 30% of formal businesses this was the main reason. Access to finance was also the main reason for the bleak employment expectations with 47%, again mostly for informal businesses (63%). Access to and cost of finance remains an obstacle to expansion for businesses in Namibia, in particular for the informal sector. In terms of employment plans, businesses were pessimistic.

Figure 3: Share of formal and informal businesses that accessed finance during 2008/9 by institution in %

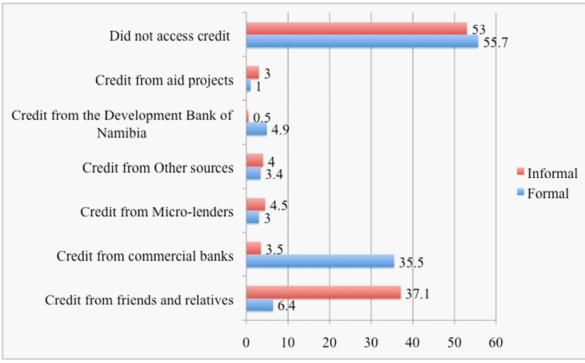
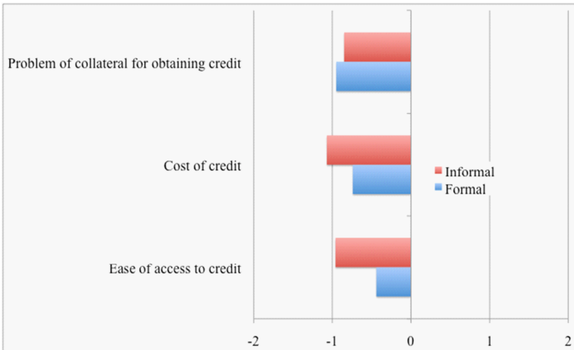


Figure 2 shows the share of businesses that accessed finance from various sources during 2008/2009. While most business did not access credit in 2008/2009. Informal businesses that did so mostly through family and friends and formal businesses mostly through commercial banks. Businesses found it difficult to access credit, it to be too expensive and lack collateral was a major difficulty to access it.

Figure 4: Rating of the ease of accesses finance



4. Access to formal financial services for the informal sector

Namibia is struggling with access to formal financial services for its citizens and the informal sector. In addition to the underlying structural limitations; risk-averse bankers, unsuitable financial products and high bank charges have also been blamed for this state of affairs. Poor people with irregular income and informal businesses often have no choice but to make use of informal financial services, which are many times more expensive than formal ones. Formal financial services are usually only extended to those with a regular income or collateral. Informal businesses also often lack the required accounting skills and systems to generate necessary data and business plans to convince a bank to extend loans to them.

A critical issue to overcome is that of asymmetrical information. Someone without a bank account approaching a bank for a loan is likely to be rejected unless collateral is at hand. The bank has no transaction history for this person or informal business and hence does not know anything about the applicant's creditworthiness. Transaction patterns can be used to predict whether or not a customer will be able to repay a loan. Absence of a transaction history means that the ability to repay loans is unknown to banks, making it risky for banks to serve such a person unless the loan is fully collateralised. Few individuals in the informal sector have access to collateral. They either have their own informal small businesses (such as street vendors) or work on an ad hoc basis.

Mobile banking (m-banking) can be seen as one solution to these problems. Despite having been around for some time in several African countries, the existing offerings are mostly value-added services where the mobile phone is a complimentary channel to operating an existing bank account. Such services are not geared towards the inclusion of the poor and unbanked.

Mobile payment or mobile transfer mechanisms such as MPESA offer the opportunity to generate transactions histories if the transaction fees are very low or if transacting money is free.

This requires a re-thinking of how banking is done in Namibia. Currently banks make their money to a large extent from service fees instead of making it from financial intermediation. Charging for cash deposits, for example, keeps money out of the banking system, the opposite of what banks should aim for. The crucial role of the banking system for the economy is to raise funds and channel it into productive investments. Charging fees for depositing money limits the money banks can raise cheaply. Namibian banks pay very little for money sitting in savings or check accounts, less anyway than what they have to pay to the Bank of Namibia for borrowing money. Ideally banks would make their money from the interest rate spread, the difference between the interest banks pay for getting capital and what they charge for lending it to their clients.

Scrapping bank fees for transactions, withdrawals and transfers would provide banks with cheaper access to capital, higher transaction volumes and better tools to assess the creditworthiness of their customers. What is true for the formal sector is even more true for the informal sector. A free mobile based transaction system would enable banks to generate transaction histories and automatically extend (without bankers involvement) overdrafts based on these transactions.

4.1 A bank account for every mobile number

In order to use the mobile phone as a strategy for the integration of the unbanked into the world of formal banking, instead of adding a mobile phone as an additional channel to an existing bank account, a more transformational option would be to add a bank account to an existing mobile phone. Turning each mobile phone number on an operator's network into a bank account number would push the access frontier considerably.

Currently mobile operators already maintain some kind of bank account for each of their subscribers in order to track their airtime usage. When airtime is purchased these accounts are credited and when calls are made or SMSs sent they are debited. These airtime systems could be extended to cater for add-on financial services, which extend to the unbanked and the informal economy. An operator could provide its subscribers with multiple accounts associated to their mobile phone, one for airtime, one for money value and another one for savings, for example.

From a software and hardware perspective, it would be straightforward to give the user a second or third wallet that stores money electronically. Administered on a secure server, money can be transferred using the same channel and technology as for airtime transfers. Airtime purchase could then be a transfer between the two wallets. At that point of transfer, VAT would be applicable and a reverse transfer would not be possible.

These, so called mobile wallets (Comninos et al 2009), would help overcome some of the existing obstacles to getting a bank account and other financial services. It could mean establishing an alternative transaction mechanism to the expensive formal banking system, one that makes transacting electronically as convenient and cheap as dealing in cash.

Mobile operators should love mobile wallets since they will no longer loose money in the distribution channel. Prepaid customers can load airtime anytime anywhere and operators do not need to sell airtime through super markets and other retail outlets any more. There would be no need for scratch cards anymore.

The GSM platform is already being used in Africa as a transfer mechanism, though against transactions fees. Kenya's MPESA, for example, is a mobile-based alternative for non-bank-account transfer mechanisms such as Western Union and MoneyGram. It is clearly cheaper as suggested by Table 6, but not yet cheap enough to function as an alternative currency. The charges are too high for micro-payment (i.e. to pay for small items such as bread or milk). As the amount of money transferred increases, the transaction costs become more reasonable.

Table 6: Example MPESA Cost of non-bank domestic transactions

Amount in Khs	M-Pesa to M-Pesa				M-Pesa to Non M-Pesa user			Domestic Transfer Western Union	
	Send money	Withdraw cash by a non M-Pesa user	Total cost of transfer M-pesa to M-pesa user		Send money to a non M-Pesa user	Withdraw cash by registered M-Pesa user	Total cost of M-pesa user to non user transfer		
100	30	25	55	55%	75	0	75%	500	500%
500	30	25	55	11%	75	0	15%	500	100%
1,000	30	25	55	5.5%	75	0	7.5%	500	50%
5,000	30	45	75	1.5%	100	0	2%	500	10%
10,000	30	75	105	1.1%	175	0	1.8%	600	6%
20,000	30	145	175	0.9%	350	0	1.8%	700	3.5%
35,000	30	170	200	0.6%	400	0	1.1%	1,200	3.4%

Sources: MPESA and Western Union and Cominos et al 2009

The poor can participate in the formal economy if access is granted using micro-payments – a simple maxim demonstrated by C.K. Prahalad (2006) in his book The Bottom of the Pyramid. Micro-payments will only be widely used if they are easy to use and involve minimal or no transaction costs. A mobile wallet with zero or extremely low transaction costs, allowing for micro-payments is likely to be a successful and transformational business model. If such a model were widely used, customers could build up reliable transaction histories, opening future avenues towards deeper financial services. Banks would be able to service the informal economy profitably.

4.2 Regulatory aspects

In many regards, the telecommunication and financial sectors are similar. Both are crucial for economic and social development, and both have only a few players (oligopolies) and need to be regulated in the public interest. In future not only will banks and mobile operators be required to cooperate more closely, but the different sector regulators will have to do that as well.

Mobile wallets could be operator or bank specific or they could be completely independent, operating on servers that communicate with banks, individuals and companies across operator networks. Financial service provision requires a banking licence in Namibia. Operators may apply for a banking licence or co-operate with a bank. Banks could also become virtual network operators, a mobile operator without own infrastructure that roams on the network of other operators.

From an economic or developmental perspective the ideal would be a mobile payment system that is independent of banks and operators and allows transfers and interactions between any bank and any operator. The formal financial system, with its automatic clearing bureau, is such a system, but it tends to be very expensive.

An alternative would be a system similar to the peering system used for Internet traffic, where operations carry traffic for each other without charge. An operator should have no objections to receive money from another operator, which is different from terminating a call for another operator.

A mobile payment system would need to replicate this formal system but with a zero or extremely low transaction cost for the actual users. The current value being generated by both mobile operators and banks in Africa makes a partnership for such a system between banks and operators unlikely. A third party who is able to understand the dynamics of a volume-based, small margin business is more likely to succeed.

Just like convergence forced the integration of broadcasting and telecommunications, so mobile banking is forcing the convergence of the financial and telecommunications sectors. Unfortunately, the convergence of two such heavily regulated industries means that this potential is unlikely to be met unless policy-makers lay the ground rules for innovation. Recommendations could include encouraging the development of industry standards for mobile banking security based upon open access principles and changing regulatory systems to allow mobile operators to become banks, or banks to operate Mobile Virtual Network Operators (MVNOs).

Policy-makers need to make some strategic decisions about how best to leverage the opportunity that mobile banking represents. In order to allow innovation, regulators, on the other hand, quickly have to learn to grapple responsively and flexibly with new issues that appear to extend beyond their domains of expertise. From the solutions that emerge, the market can help decide what is most appropriate given the African context.

5. Conclusion

The current economic conditions are seen as neither good nor bad by responding businesses. Businesses are far more prepared to invest than they are to employ. A reason for that could be Namibia's restrictive labour laws that make it a risk for a business to employ someone. Generally, informal businesses are more optimistic than formal businesses.

Access to and cost of capital remains the biggest obstacles to business performance and further investment (53%). Family and friends remain the main source for business loans in the informal and/or micro business sector.

Support programmes for the informal sector need to be different from the formal sector. Informal businesses require help in raising capital to expand. They also need investment and accounting knowledge. Including entrepreneurial skills like financial management and accounting in secondary school would boost skill-levels and prepare learners for the harsh Namibian realities of only a small share of school leavers finding formal employment and others being pushed into entrepreneurship or informal employment.

Skills upgrading for informal businesses and adult education is equally important. Seminars and workshops could be offered once a month at informal markets, after hours. These could address accounting, financial management, compiling business plans, business strategy, basic computer and technology training.

Serving the informal sector profitably and sustainably requires a radically different approach. Tweaking the existing banking system will not achieve a breakthrough in service provision to informal SMEs or the poor. A paradigm shift needs to occur in order to determine how the poor and informal businesses can be profitably brought into the banking sector. Mobile wallets have the potential to provide an urgently needed breakthrough. Banks need to get back to basics and focus on making money through financial intermediation rather than through transaction fees. Policy-makers and regulators need to ensure that evolving systems serve the broader objectives of economic growth and development as well as protect consumer interests, while creating an environment that encourages and rewards innovation.

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The role of SMEs in employment creation and economic growth: lessons from other countries[1]

by
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Abstract

The importance of the contribution – to GDP, to employment, to civil society - made by the SME sector has been recognized by governments around the world. Much discussion has focused on how the public sector can best support the small business sector, and this paper will make the case that creating an environment where SMEs have adequate access to financial services (to include deposit and money transfer services, for example, as well as lending) is one of the most important measures a government can take.

List of Abbreviations used

CGAP	Consultative Group to Assist the Poor
EU	European Union
GDP	Gross Domestic Product
GNI	Gross National Income
IFC	International Finance Corporation
MENA	Middle East and North Africa
OECD	Organization for Economic Co-operation and Development
SME	Small and medium enterprise
WDI	World Development Indicators

1. Introduction

The Small and medium enterprise sector (henceforth 'SME') is recognized universally as a key force in driving forward economic development. SMEs are active in virtually every sector, either as direct providers of services or goods or, alternatively, as component parts of complex supply chains, and a significant percentage of the world's economically active population derives it's living from SME sector employment.

[1] References to the various examples cited are made for illustration purposes only. Readers should carry out their own assessments and due diligence of the effectiveness of the policies and interventions described. References to examples should not be seen as implying any kind of approval, recommendation or support by IFC

While the barriers to growth faced by SMEs do vary from country to country, some common themes tend to emerge:

1. Business regulation (how easy it is to open and close a business and obtain the necessary operating permits and licenses for example);
2. Infrastructure (unpredictable electricity supply, logistics of getting produce to market);
3. Corruption;
4. Access to finance (across the full range of financial services, not just credit);
5. Management capacity (having the skills across a wide range of disciplines, many of which are specialized/technical);

This paper will first of all set the scene by considering the role played by SMEs in economic development, before looking at the non-financial and then financial barriers to SME growth and development. In the final chapter, selective illustrations of interventions and initiatives adopted in other countries will be discussed. More specifically, it will focus on the issues surrounding the 'access to finance' question and will look at steps that have been taken at both the public (financial infrastructure – credit bureaus and moveable collateral registries, for example) as well as private sector levels to promote greater participation by the SME sector.

The International Finance Corporation (IFC, part of the World Bank Group) is in a particularly fortunate position to discuss these initiatives. It is in the process of undertaking (in conjunction with other multi-lateral/development financial institutions) a 'stocktaking exercise' of SME sector support and promotion activities from around the world to present to the G20 Summit meeting in South Korea from November 11 – 12 this year. Analysis of the results from this exercise is likely to feed into a series of policy recommendations to help guide the thinking of the G20 leaders as they consider how to address the challenge (posed at the G20 Summit in Pittsburgh in September 2009) of promoting SME development. This paper is based in part on some of the findings that have emerged from this research.

2. The role of SMEs in economic development

2.1 The definitional question

The term "SME" typically encompasses a broad spectrum of definitions across countries and regions. Many countries and international organizations set their own guidelines for defining SMEs, often based on the number of employees, sales, or assets. For example, the European Union (henceforth 'EU') defines SMEs as firms with between 10 and 250 employees, with less than Euro 50 million in turnover or less than Euro 43 million in balance sheet total (Table 1.1). This definition explicitly distinguishes between micro firms and SMEs. Although the EU thresholds are very high for most developing countries, this definition is presented here as an illustration because the EU has made more effort to standardize the SME definition than any other part of the world, and today at least 27 countries follow the definition.

Table 1.1: European Union SME Definition

Firm size	Headcount	Turnover	or Balance sheet total
Medium	< 250	≤ € 50 million	≤ € 43 million
Small	< 50	≤ € 10 million	≤ € 10 million
Micro	< 19	≤ € 2 million	≤ € 2 million

Source: Recommendation 2003/361/EC

The World Bank's own definition uses number of employees, asset size and annual sales turnover as its definitional parameters, but also has a series of loan size ranges as a proxy definition for the micro, small and medium client segments. These are illustrated below (Table 1.2).

Table 1.2: World Bank SME Definitions

Firm size	Employees	Assets	Annual sales
Micro	< 10	< $100,000	< $100,000
Small	< 50	< $3 million	< $3 million
Medium	< 200	< $15 million	< $15 million

Source: World Bank
Note 1 - Enterprises must meet at least 2 out of 3 characteristics.
Note 2 – Loan size proxies are as follows:
Micro - < $10,000
Small - < $100,000
Medium - < $1 million ($2 million for some more advanced countries)

Many countries adopt a definition of SME that covers all firms with less than 250 employees, therefore including micro firms. Under this definition, the vast majority of all firms are SMEs, with the share of SMEs in the firm size distribution typically ranging from 95 percent and 99 percent[2]. The definitional issue gets further complicated by the fact that individual banks in the same country also use different definitions of SME, for their own strategic and risk management purposes. [3] [4] For instance, among banks in IFC's Middle East and North Africa region (henceforth 'MENA'), the cut-off between small and medium firms ranges from 5 to 50 employees, and the cut-off between medium and large firms ranges from 15 to 100 employees.[5] For the purposes of this paper, however, no attempt will be made to arrive at a consensual definition of what constitutes a SME and where examples of support initiatives are mentioned, they should be understood in the context of the definition found in that country.

[2] *OECD (2006)*
[3] *Beck, Demirguc-Kunt, and Peria (2008)*
[4] *Indeed, in its work with banks on this issue, IFC encourages banks to be creative in their definitions of their SME target market – it is more important to have a definition than to worry about the exact parameters that are being used.*
[5] *Farazi, Khouri, Pearce, and Rocha (2010)*

2.2 SMEs and their role in the economy

SMEs account for a significant share of employment and GDP around the world, especially when taking into account the informal sector. In developed countries, SMEs employ around 67 percent of formal sector workers, while in developing countries; this number is lower at around 45 percent. Similarly, SMEs contribute a sizeable share to formal Gross Domestic Product (henceforth 'GDP') – 49 percent on average in high income countries and 24 percent on average in low income countries, respectively (Figure 1.1).[6] (2005 figures from the Institute for Public Policy Research suggest that SMEs account for 20% of employment in Namibia, and contribute 12% to GDP. The government's 'Vision 2030' clearly states that SMEs should act as the locomotive that drives the economy forward to achieve '….human development, equitable and balanced growth, with a growing industrial sector [and] modernized agriculture….'). The contribution made by SMEs to employment and GDP in developing countries seems comparatively modest, but estimates suggest that the informal sector (which consists essentially of SMEs) accounts for up to 48 percent of the total labour force and 37 percent of GDP in developing countries. The corresponding numbers for developed countries are much lower, 25 and 16, respectively[7] (Figure 1.2).

Figure 1.1: Share of Formal SMEs in labor force and GDP

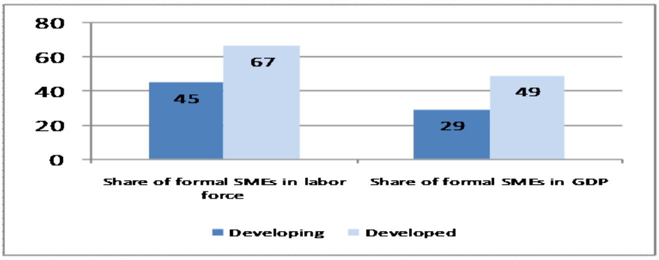
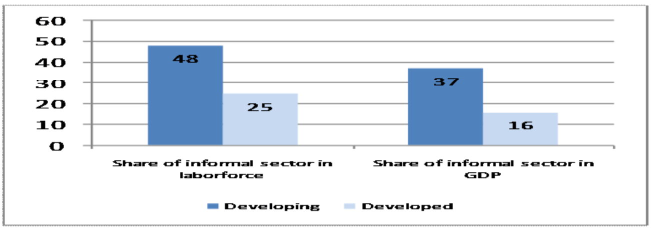


Figure 1.2: Share of Informal SMEs in Labour Force and GDP [8]



6 The data refers to employment and GDP in formal firms with less than 250 employees for 76 developed and developing countries. Numbers by income group are simple averages of all countries that fall in the income group. The definition of formal here generally refers to firms with formally registered workers. However, the data comes from a large number of country specific sources and some general databases, such as OECD, Eurostat, and UNEC, implying that the definition of formal firms may vary within the data. Table II in the appendix to Ayyagari, Beck, and Demirgüç-Kunt (2007) provides the list of data sources.

7 Ayyagari, Beck, and Demirgüç-Kunt (2007). Data on SME contribution to GDP and employment are scarce. Figures 1.1 and 1.2 although preliminary and illustrative are presented here to depict the importance of the informal sector (which typically comprises SMEs) in the context of developing countries.

8 Source: Based on Ayyagari, Beck, and Demirgüç-Kunt (2007). Note: The informal sector includes all informal sector firms irrespective of their size and sector of operation.

Figures 1.3 and 1.4 illustrate further the importance of the informal economy for developing countries. At low levels of per capita income, informal GDP reaches as much as half of recorded GDP, implying an important contribution by informal SMEs to economic activity. Similarly, Figure 1.4 shows that the coverage of the social security system (a measure of job formality) is very small at low levels of per capita income, implying that informal SMEs may absorb a significant share of the labour force which is not employed by the formal sector.

Figure 1.3: Size of Informal Economy vs. GNI Per Capita [9]

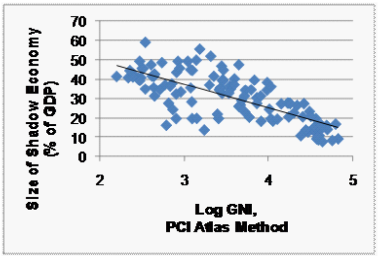
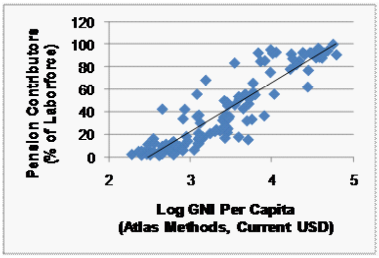


Figure 1.4: Social Security Coverage vs. GNI Per Capita

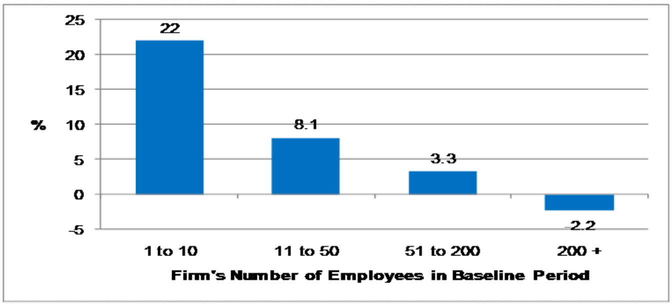


Source: WDI based on national sources, either household surveys or national social security administrations.

SMEs create more jobs than large firms, and this is especially the case for recently created firms. Several studies have found that SMEs create more jobs than large firms, both in developed and developing countries. SMEs also shed more jobs than large firms, but job creation tends to outweigh job destruction, so that net job creation is higher in SMEs than in large firms[10]. This flux between job creation and job destruction characterizes the innovative, competitive, and dynamic nature of SMEs. Data on employment growth from the World Bank's Enterprise Surveys, shows that, on average, employment growth rates are highest in smallest firms and decline monotonically with firm size (Figure 1.5). Research has also shown that business start-ups, contribute greatly to overall job creation. (In fact, without counting jobs created by start-ups, in the United States, the net employment growth rate is negative on average[11]).

[9] Source: Size of shadow economy from Schneider and Buehn (2009), GNI per capita from World Development Indicators
[10] See Globalization and Economic Policy Centre (2010), Aterido, Hallward-Driemeier and Pagés (2009), Klapper and Richmond (2009), OECD (1997) and (2003a)
[11] Haltiwanger, Jarmin, and Miranda (2009)

Figure 1.5: Employment Growth Rates by Firm Size [12]



There is evidence that, in developing economies, SMEs could contribute more to economic development than they currently do. SMEs tend to be small in developing countries, and the percentage of medium size firms is often low. A number of studies show that small firms and large firms account for most of the employment in developing countries, with medium sized firms only accounting for a relatively low fraction of overall employment [13]. The fact that SMEs tend to be smaller in developing countries suggests that they face greater constraints to growth, including financial constraints.

Enterprise Surveys conducted by the World Bank also show that SMEs face more severe financing constraints than large firms. SMEs face a host of non-financial and financial constraints as shown in Fig. 1.6, especially in low income countries. By contrast, although large firms also face generally the same constraints, they seem to be much less constrained by the lack of access to financing, at all income levels (Fig. 1.7). Other research on obstacles to firm growth also shows that the smallest firms are most adversely affected by financial and non-financial constraints and that these constraints are particularly severe in developing countries[14] .

Figure 1.6: Financial and Non-financial Barriers to SME Growth by Country Income Group [15]

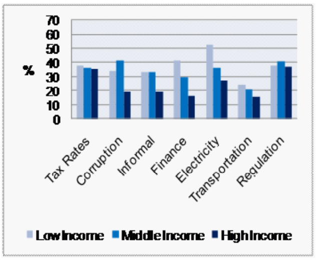
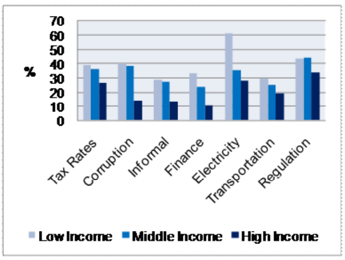


Figure 1.7: Financial and Non-financial Barriers to Large firm Growth by Country Income Group



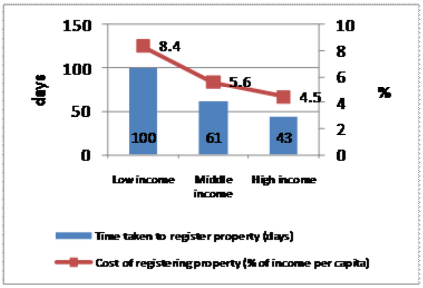
12 Source: Aterido, Hallward-Driemeier and Pagés (2009)
13 Tybout (2000), Sleuwaegen and Goedhuys (2002), Snodgrass and Biggs (1996)
14 See Beck, Demirgüç-Kunt, and Maksimovic (2005)
15 Source: World Bank Enterprise Surveys (2006-09).Note - Regulation refers to licenses and permits, tax administration, labour regulation, and functioning of courts. 2. Competition in the informal sector as a constraint was not asked for high income countries.

2. Non-financial barriers to SME development

Prior to exploring financial constraints to SME development, it is important to acknowledge the existence of a wide range of non-financial barriers that disproportionally affect SMEs. Moreover, oftentimes, the non-financial and financial barriers can be correlated and this relationship may be strong in some cases. For example, improvement in physical infrastructure can generate important productivity gains and improve the prospects of higher rates of returns, facilitating access to a wider range of financial services.

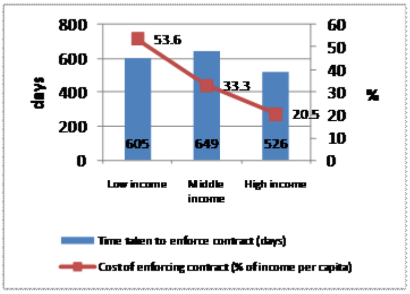
There are significant differences across countries in terms of the quality of the business environment. This is evident from the Doing Business indices (made up of a variety of business relevant indicators) which rank countries based on their ease of establishing, running, and closing an enterprise. Figures 2.1 and 2.2, for example, demonstrate the differences among countries in terms of the time taken and costs incurred in registering property and enforcing contracts, the indicators particularly relevant for financial access. Not surprisingly, such costs are lower in high income countries than in lower income ones. These results are also confirmed by firm level studies (as shown below).

Figure 2.1: Registering Property



Source: World Bank, Doing Business Indicators 2010

Figure 2.2: Enforcing Contracts



Source: World Bank, Doing Business Indicators 2010

Namibia is ranked 66th overall (out of 180 countries) in the latest World Bank 'Ease of doing business' report. However, in two important areas – starting a business and registering property – Namibia ranks much lower (123rd and 134th respectively). These rankings are relevant to this paper insofar as they suggest that:

a. More needs to be done to facilitate the growth of the formal sector (high barriers to entry will tend to push business into the informal environment):
b. Difficulties in registering property would normally increase the difficulties enterprises have in accessing finance, since they are less likely to be able to offer title to property as collateral for bank funding[16] ;

[16] *Note, however, that Namibia ranks 15th/180 in a measure of the ease of accessing credit in the World Bank's survey, which suggests that this factor is less of an obstacle in Namibia than it is elsewhere.*

Enterprise surveys also show that specific constraints affect smaller firms in developing countries disproportionately more than their counterparts in the developed markets. Some of the non-financial components of the business environment that SMEs most frequently rate to be major obstacles are lack of electricity, heavy regulation, high tax rates, practices of competitors in the informal sector, and corruption. SMEs in high income countries are less likely to report major non-financial obstacles than SMEs in low and middle income countries, although they complain about high tax rates and heavy regulation as well.

In low income countries, the one factor that SMEs most frequently perceive to be a major obstacle is electricity breakdowns, with 52 percent of SMEs viewing electricity as a major obstacle. Although this obstacle is self-reported, additional statistics from the Enterprise Surveys suggest that lacking electrical infrastructure could hinder SMEs' operations since SMEs often do not have alternative sources of electricity. On average, only 22 percent of small firms own a generator, compared to 35 percent of medium-sized firms and 51 percent of large firms (the fixed costs associated with the acquisition and installations of generator capacity are substantial). The importance of electricity as an obstacle to SMEs' operations declines as country income increases and electricity infrastructure becomes more developed. In high income countries, only 6 percent of SMEs report electricity to be a major obstacle.

The second component of the business environment that is most frequently perceived to be a major obstacle for SMEs is regulation, with over 36 percent of SMEs rating regulation as a major obstacle in all countries. SMEs often have less capacity than larger firms to navigate through the complexities of regulatory and bureaucratic procedures. Research has shown that countries that have lower entry costs and lower costs of registering property have a larger SME sector in manufacturing[17] . Moreover, regulatory reform can foster the creation of formal SMEs. For example, reforms in Mexico and in Colombia that simplified business registration procedures led to increases in the number of registered businesses[18].

Removing regulatory obstacles can also significantly increase SMEs' access to finance. First, a lower cost of registering property may lead to an increase in collateralizable assets, since it will become more affordable to SMEs. Secondly, more efficient courts and legal procedures could also reduce the costs to lenders of enforcing their rights against collateral taken in support of lending (see also later comments in Chapter 3 about the importance of financial infrastructure). Overall, research from around the world suggests that efforts to promote SME growth through other policies are less likely to be successful if regulatory shortcomings are not addressed in the initial stages to create the right conducive environment.

More than 33 percent of SMEs in low and middle income countries report tax rates, as well as the presence of unregulated competition in the informal sector[19], to be major

17 Ayyagari, Beck, and Demirgüç-Kunt (2007)
18 Bruhn (2009) and Cardenas and Rozo (2007)
19 The Enterprise Surveys questionnaire does not define "practices of competitors in the informal sector" further. Firms are open to interpret this obstacle in their own way.

obstacles to growth. These two obstacles are closely linked, since governments in developing countries often impose heavy taxes on the formal sector if the informal sector is large, in order to compensate for forgone tax revenue from informal firms. Typically, the practices of competitors in the informal sector become an obstacle for formal firms due to the fact that informal firms do not pay taxes, allowing them to offer lower prices and to thereby attract away customers from their formal sector competitors.

SMEs in countries with different per capita incomes complain about the overall tax burden, albeit the breakdown of taxes differs across countries with different income levels, since employers in higher income countries tend to pay higher payroll taxes. According to the World Bank's Doing Business report, the median profit tax rates are higher in low and middle income countries (20 percent) relative to the median in high income countries (14 percent). However, high income countries tend to have higher labour-related taxes than low income countries. Social security contribution rates for both employee and employers taken together are 25 percent in high income countries, about 20 percent in middle income countries, and 17 percent in low income countries.[20]

SMEs in low and middle income countries also frequently cite corruption as a major obstacle. About 42 percent of firms in middle income countries perceive corruption to be a major obstacle, a number which is slightly lower in low income countries (34 percent), and much lower in high income counties (18 percent). Typically, SMEs are somewhat more likely to pay a bribe to get things done than large firms since SMEs have fewer resources or bargaining power to avoid paying bribes. (However, it should also be noted that the higher perceived corruption levels could also reflect the fact that SMEs might not always be in full compliance with local regulations, which of course makes them an easier target for corrupt officials).

SME specific characteristics also clearly put them at disadvantage when compared with large firms. On top of obstacles arising from the investment climate, SMEs face several non-financial barriers that are related to the capacities of SMEs themselves. The small size of these firms implies that managers (or owners) of SMEs often need to perform a wider range of tasks than in larger firms since there is less room for specialization. This requires diverse skills that SME managers may not have, particularly in developing countries where the quality of management education may be lower than in developed countries[21]. Moreover, SMEs are unable to take advantage of the economies of scale related to accounting, business planning, and market research to the same extent as large firms can. This may lead SMEs to under-invest in activities and services that could potentially enhance their transparency and productivity. For example, data from the Enterprise Surveys indicates that only 37 percent of small firms have their annual financial statement reviewed by an external auditor, compared to 58 percent of medium-sized firms and 79 percent of large firms.

[20] *OECD, ILO, ISSA, and national sources*
[21] *Chaudhry (2003)*

In several developed countries, SME management training appears to have been successful in reducing failure rates of small firms[22]. Preliminary findings from recent research in Mexico also indicate that management consulting for SMEs can increase productivity, sales, and profits[23]. A related constraint for SMEs' operations and growth is lack of financial education. Recent evidence suggests that levels of financial literacy are often low among small business owners, which can potentially pose difficulties for managing the firm's finances effectively[24].

Lack of business and management skills can magnify financial barriers for SMEs. Low levels of financial literacy can prevent SMEs from adequately assessing and understanding different financing options and from navigating complex loan application procedures. Similarly, the fact that SMEs' accounting and financial statements are often not transparent makes them (at least in the perception of many bankers) risky borrowers who thus make for less attractive clients. Capacity building of SMEs in terms of preparing financial statements and business plans, as well as improving their financial literacy and management training is shown to have positive impact on SME development.[25]

3. Access to finance as a key constraint to SME development

This chapter describes the SME life cycle and financing needs, and reviews evidence on the SME financing gap based on the available data from the enterprise and financial institution sides. It discusses the reasons why SME Finance remains a challenge, stressing the lingering deficiencies in the legal/regulatory framework and in financial infrastructure in many emerging countries, and finally, it also discusses the policy interventions that have been typically introduced to alleviate the access constraint, while also pointing out the possible shortcomings of these interventions.

3.1 SME Life Cycle and Financial Needs

Financial access can help firms start up and expand their businesses through inter alia development of new products and production processes, and investment in human capital. Firms often depend on informal sources of funding in the very early stages of their development. External sources, however, become important as firms start expanding, and their availability can determine decisively the growth trajectory of SMEs.[26] Internal financing sources typically include entrepreneur's own savings,

22 OECD (2003b)
23 Bruhn, Karlan, and Schoar (2010)
24 Studies on the link between financial literacy and business outcomes are currently ongoing. For example, Bruhn and Zia conducted a survey among youth entrepreneurs in Bosnia who are microfinance clients to assess their financial knowledge through a series of questions. This survey shows low levels of financial literacy. The same project provided financial literacy training to a randomly selected group of youth entrepreneurs. A follow-up survey will be conducted in mid 2010, which will provide information on whether the training improved levels of financial literacy, as well as business outcomes.
25 European Commission (2006)
26 Entry and growth of small firms is facilitated in countries that provide a supporting enabling environment, including easier access to finance (Klapper, Laeven, and Rajan, 2006).

retained earnings or funding through the sale of assets. The external sources of finance can be informal (family and friends or supplier finance) and formal (debt or equity). Figure 3.1 and 3.2 present the proportion of firms' working capital and investment needs funded by various external financing sources, for firms of different sizes.

Figure 3.1: External Financing Sources for Working Capital Needs[27]

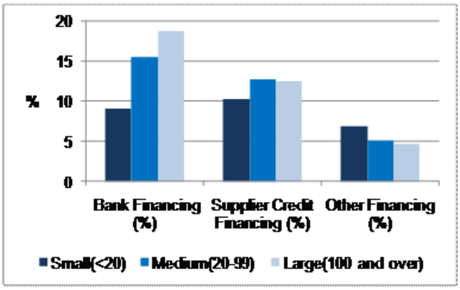
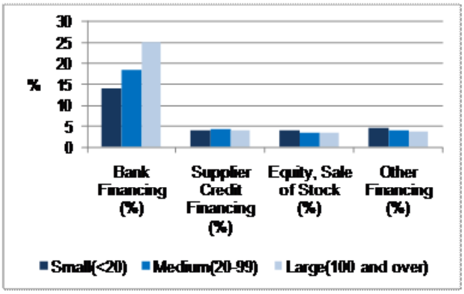


Figure 3.2: External Financing Sources for Fixed Investment Needs



As illustrated in Fig. 3.1 and 3.2, bank financing remains by and large the most important source of external finance to SMEs. Banks finance a significant proportion of companies' investment finance needs and are also the major provider of financing for working capital. Moreover, SMEs need a variety of additional financial services that only commercial banks are well positioned to provide. These include cash management, insurance, transfers, and other transactional products.

Another important source of finance for many SMEs around the world is supplier credit. Such transactions typically happen between two businesses. Trade credit allows businesses to delay their payment for goods and services purchased (which thus helps in effective cash flow management) and may substitute for financing for short-term bank credit or other more formal arrangements. Trade credit is usually used to meet short-term working capital needs.[28]

Equity financing is often necessary to enable firms to grow, invest in fixed assets, and support increased needs for debt. Typically, private equity investors receive a return on their investment through an IPO or a sale of the controlled company to a larger one. Private equity investment in start-ups and very young firms is also known as venture capital finance. In recent years, many private equity companies have started investing in SMEs in developing markets. Some countries have also created SME stock exchanges to facilitate access to public funds, although the performance of these exchanges has proven to be mixed.[29]

27 The source for Figures 3.1 and 3.2 is World Bank Enterprise Survey data.
28 OECD (2006)
29 OECD (2009) provides a comprehensive review of equity finance in the early stages of the life cycle.

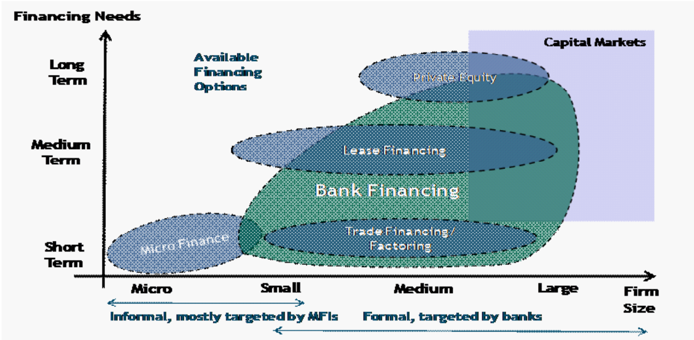
Factoring clearly appears as an important complementary source of working capital finance for SMEs; especially in jurisdictions where the financial infrastructure presents gaps (see Figure. 3.1 above, 'Other Financing'). Factoring entails the purchase by the lender of a firm's accounts receivables and the collection of invoices from the parties that owe money. Factoring addresses the problem of SME opacity by focusing on the quality of the obligor. In recent years, the concept of reverse factoring as a financial instrument has become popular. With reverse factoring, the financial institution purchases receivables only from high credit quality buyers, resulting in the provision of low risk loans to high risk suppliers (SMEs). Reverse factoring is particularly useful for SMEs in countries with underdeveloped contract enforcement regimes and weak credit information systems. [30]

Likewise, leasing appears as an important complementary source of investment finance, particularly in countries where the collateral regime and the information infrastructure are weak. This is particularly the case for smaller firms (as suggested in Figure. 3.2 above, "Other Financing"). The advantage of leasing lies in the fact that it focuses on the firm's ability to generate cash flows from business operations to service the leasing payment rather than on its credit history or ability to pledge collateral. A second way-out for the leasing providers in case of payment default is the repossession and sale of the leased asset, which provide additional risk mitigation.

In developing countries, and also in developed countries to a lesser extent[31], the offer of available financial services only partially meets SME needs – a phenomenon that is commonly referred to as the SME Finance Gap. Fig. 3.3 qualitatively illustrates the SME Finance Gap by looking at the most commonly used financing tools across two dimensions: firm size and maturity of financing. Traditional banking models typically target the largest firms, and while commercial banks in developed countries have become increasingly able to serve the needs of smaller firms, banks in most developing countries still mostly limit their SME activities to fully secured working capital facilities. Microfinance companies have developed specific skills and business models to provide small loans to the informal sector and the smallest formal firms, but they have limited ability to accompany client firms as they grow. They also lack the ability to offer additional non-lending products that are critical to their clients. Leasing and factoring volumes remain small in most developing economies, yet these products could help address some of the financing needs of smaller and informal firms. Finally, only a very limited number of small firms that are innovative and have clear growth potential are able to access venture capital.

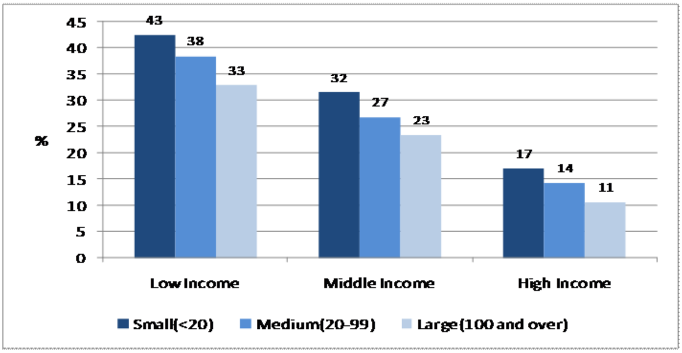
[30] *Klapper (2005)*
[31] *OECD, 2006. "The SME Financing Gap, Vol. I: Theory and Evidence"*

Figure 3.3: A Representation of the SME Finance Gap



SMEs in low and middle income countries perceive access to financing as a major obstacle to growth and development, indicating that most of the financial instruments discussed above are not easily available in most of these countries. The World Bank Enterprise Survey results indicate that SMEs in developing countries are more likely to report that access to finance is a major obstacle to their development than SMEs in developed countries. As shown in Figure 3.4, in low income countries, 43 percent of small enterprises and 38 percent of medium firms report that access to finance is a major obstacle to their operations. The equivalent figures in middle income countries are 32 and 27 percent, respectively. Financial access is reported to be a relatively weaker constraint in high income countries.[32]

Figure 3.4: Percentage of Firms Viewing Access to Finance as a Major Obstacle by Firm Size and Country Income Group[33]



[32] Source: World Bank Enterprise Surveys (2006-09). The Enterprise Surveys define small firms to have fewer than 20 employees and medium size firms to have between 20 and 100 employees. Data are for the most recent year available for each country, ranging from 2003 to 2009. Statistics by country income group are simple averages of the countries in each group.

[33] Source: World Bank Enterprise Surveys (2006-09). The Enterprise Surveys define small firms to have fewer than 20 employees and medium size firms to have between 20 and 100 employees. Data are for the most recent year available for each country, ranging from 2003 to 2009. Statistics by country income group are simple averages of the countries in each group.

3.2 Why does financing SMEs Remain a Challenge?

Lingering deficiencies in the enabling environment help explain the constrained access of SMEs to finance. The enabling environment is defined here to include both financial infrastructure and the overall legal and regulatory framework for financial institutions and instruments. Financial infrastructure includes the informational, contractual, and transactional frameworks that provide the basis for financial intermediation. The legal and regulatory framework for finance is the collection of laws and secondary regulations on financial institutions and instruments that provide the foundations for market development and the overall degree of market competition. This includes, for example, banking, insurance, leasing, factoring, and security laws, as well the respective bodies of secondary regulations and guidelines. Effective legal and regulatory frameworks promote access to finance while preserving financial stability. This is achieved by expanding the range of financial institutions and instruments and promoting market development and competition, while submitting financial institutions and agents to sound prudential rules.

The legal and regulatory framework plays a critical role in improving the landscape in which SMEs are able to grow and develop. For example, banking regulation that promotes market competition may help to exert downward pressure on margins and encourage banks to develop more offerings to the SME segment because of competition constraints in other areas of their business. (This kind of regulation tends to be a driver of SME lending, according to SME surveys conducted by the World Bank). Legislation that promotes leasing and factoring also promote access to finance by SMEs, especially in environments where financial infrastructure remains weak. The slower development of leasing and factoring in most developing countries may reflect gaps in the legal and regulatory environment in these countries. Legislation that facilitates bond and equity finance for large firms may promote competition to bank lending, reducing bank margins on traditional business lines and inducing banks to diversify lending to SMEs. Financial regulation can also become a hindering factor, however, when it mandates policies such as interest rate ceilings that do not allow banks to cover adequately lending risks (which can of course discourage lending to the SME segment).[35]

One particular regulatory framework that has been much discussed in the context of SME Finance is the Basel II framework, which seeks to align banks' capital allocations with the risk characteristics of their loan portfolio. After considerable initial debate, the effects of Basel II on SME Finance are now considered to be neutral or positive.

[34] See De la Torre, Peria and Schmukler (2010), Beck, Demirguc-Kunt and Peria (2008), and Rocha, Farazi, Khouri, and Pearce (2010).
[35] IFC (2009)

3.3. Financial Infrastructure

Financial infrastructure as defined here includes accounting and auditing standards, credit reporting systems (credit registries and bureaus), collateral and insolvency regimes, and payments and settlement systems[36]. Financial infrastructure reduces the information asymmetries and legal uncertainties that increase risk to lenders and constrain the supply of finance. Financial infrastructure development improves financial access for all firms, but SMEs benefit proportionately more, as the problems of opacity and information asymmetry are more severe in the case of smaller firms.

Strong accounting and auditing standards improve SME access to finance by reducing informational opacities and encouraging lending based on financial statements, but countries must strike a balance between improving transparency and reducing the regulatory burden for SMEs. International Financial Reporting Standards (IFRS) have been adapted to SMEs and about 60 countries have adopted the SME version of IFRS.[37] Other countries have concluded that the SME version of IFRS is still too costly for SMEs, and have adopted a simpler set of obligatory standards. This includes Germany and other EU countries.[38] There are similar concerns regarding obligatory auditing. Although auditing improves the reliability of financial statements, the EU exempts firms with less than 50 employees from obligatory audits, a rule that attempts to strike a balance between the objectives of improving transparency and reducing the regulatory burden on small firms. Some studies have found that effective accounting standards are positively associated with measures of access[39], but research in this area has been limited by the lack of good quantitative indicators of the quality of financial reporting.

Public credit registries and private credit bureaus, which provide information on borrower creditworthiness, can play a fundamental role in creating a more transparent environment in which banks can approach the question of finance for SMEs. Well functioning credit information systems reduce adverse selection and moral hazard and have been shown to contribute to an expansion of credit, a reduction in lending costs and a lower incidence of non-performing loans. A considerable variation across countries is observed in the depth of credit information and the coverage of credit registries and bureaus. A credit registry or bureau will be more effective to the extent that it obtains positive and negative information from regulated and unregulated institutions (e.g. utilities, retailers), builds credit histories for a large number of potential borrowers, and processes comprehensive credit reports in a timely manner. Credit bureau information also facilitates the adoption of lending technologies based on credit scoring models.

[36] See World Bank (2009). Although the payment/settlement systems are also part of the financial infrastructure, due to their limited relevance for SME finance they are not discussed in this report.
[37] International Accounting Standards Board (2009). See iasb.org.
[38] See the European Commission's consultations on the adoption of IFRS for SMEs (European Commission 2010).
[39] La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998), Rajan and Zingales (1998), and Beck, Levine, and Loayza (2000).

The development of credit registries and bureaus improves access to finance. As shown in Figures 3.5 and 3.6, credit information coverage is positively associated with the number of loans per adult, while the existence of credit bureaus (or registries) seems to contribute significantly to financial depth, measured by the ratio of private credit to GDP. Interestingly, the existence of credit registries and bureaus seems to matter more in developing countries, suggesting a more important role for the government in promoting information sharing in these countries.[40] The development of credit registries and bureaus is particularly important for smaller firms, given the more severe problems of information opacity and asymmetry in these cases. (Note that, in the absence of any specific information about the SME itself, credit bureau information about the business owners has been shown to be an extremely reliable proxy, since most people manage the finances of their business in the same way as they manage their own personal finances).

Figure 3.5: Credit Information and Number of Loans per Adult [41]

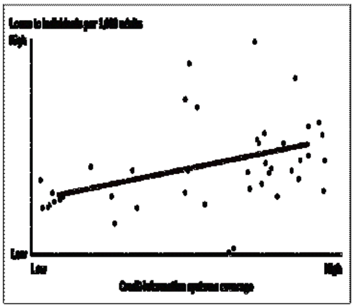
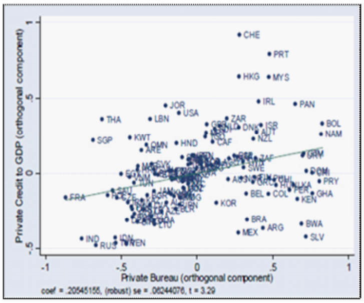


Figure 3.6: Credit Information and Private Credit to GDP [42]



By reducing the risks and losses of lenders, effective collateral regimes also contribute to a climate in which banks feel more comfortable in supporting SMEs with finance for their growth and development. A well functioning collateral regime entails a wide range of allowable collaterals (especially movable collateral), the establishment of clear priority rankings (clarifying the rights of secured creditors), efficient collateral registries (making priority interests publicly known), and effective enforcement of collateral in the case of default (both seizure and disposal, so that banks do not wait for unduly long periods). Efficient collateral regimes encourage lending by reducing the probability of default (borrowers are more certain that they will forfeit their property) and reducing lenders' losses in the event of default.

Stronger creditor rights also improve access to finance. As shown in Figures 3.7 and 3.8, countries with stronger creditor rights tend to have a higher number of loan accounts per each member of the adult population and also higher rates of private credit to GDP. [43] As in the case of credit bureaus, effective collateral regimes

[40] *Djankov, McLiesh and Shleifer (2007).*
[41] *Source: CGAP (2009)*
[42] *Source: Djankov, McLiesh and Shleifer (2007)*
[43] *Also see Chong, Galindo, and Micco (2004)*

improve access to finance to all firms, but can prove particularly effective in improving access to finance by SMEs. In countries with strong secured transactions regimes, asset based lending technologies are facilitated.[44] (Typically, SMEs have limited immovable assets but possess a wider range of movable assets). An effective secured transactions regime facilitates lending by utilizing the available movable assets as collateral in loan contracts. [45]

Figure 3.7: Creditor Rights and Number of Loans [46]

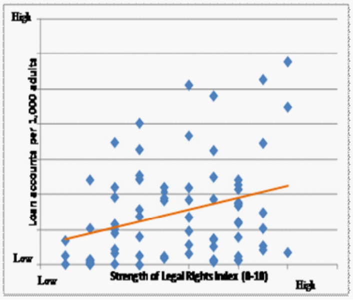
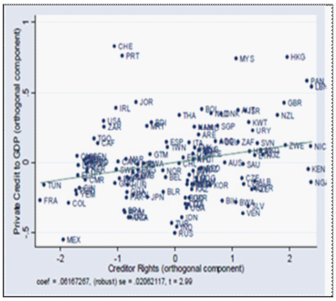


Figure 3.8: Creditor Rights and Private Credit/GDP [47]



4. Interventions – what can be done to promote access?

The various policy interventions and examples cited in this chapter are predicated on the fact that (lack of) access to finance has consistently been shown to be one of the most important barriers to SME growth and development in economies throughout the world. If SMEs can feel more confident in their ability to access finance and financial services when they require it – and not be dependent on the vagaries of the economic cycle or the willingness/ability of financial services providers to engage with them – it should be the case that employment creation and increases in productivity will follow as a natural consequence. If, on the other hand, SMEs continue to struggle to access finance for investment or even working capital needs, the likelihood is that investment plans for growth will be put on hold, new job creation will be limited and efficiency gains will be limited.

While the initiatives described here are generally focused at the micro (firm) level and aim to facilitate access to funding to support working capital and business investment needs, their impact can also, of course, be seen at the macro (SME sectoral) level:

- Promote the transition of entrepreneurs from the informal to the formal sectors;
- By creating greater levels of confidence in the ability and willingness of the financial sector to support SME development, entrepreneurs themselves feel more confident in taking a longer term view about their investment and expansion plans;

44 Berger and Udell (2006)
45 World Bank (2007)
46 Source: World Bank Doing Business Indicators (2009) and CGAP Financial Access Database (2009)
47 Source: Djankov, McLiesh and Shleifer (2007)

- Increased macro-level stability and confidence in their own personal future and that of their business enables entrepreneurs to take decisions which should lead to increased employment generation;

4.1 The Policy and Financial Infrastructure Environment

Governments play a fundamental role in ensuring a supportive enabling environment and expanding the frontier for SME Finance. Ensuring a stable macro-economic environment, an effective financial infrastructure, and a supportive legal and regulatory framework, represents arguably the most important contribution that governments can make to support the growth of the SME sector. For example, in countries where public registries are the only source of credit information, government has a direct responsibility for ensuring maximum coverage of financial and non-financial institutions, extensive reporting of the relevant information, and easy access to credit reports. Government action is also fundamental in the regulation and supervision of private credit bureaus, ensuring effective credit reporting and curbing any abuse of market power (through regulation or promotion of entry and competition). Government may also play a critical role in ensuring a legal and regulatory framework that fosters financial development and competition – in Jordan and Kosovo, for example, work has been carried out recently to establish a legal framework to foster the creation and development of a leasing industry, since leasing can represent an important financing tool for SMEs in cases where the business entity or its owner lacks viable collateral. Work is going on in other countries (China is a good example) to build a legal framework for the use of movable collateral registries, which are also designed to help banks and entrepreneurs resolve in a mutually beneficial manner the 'lack of collateral' problem faced by many SMEs. In other cases it may also play a fundamental role in introducing technological platforms for some sources of finance such as venture capital and reverse factoring.

Ensuring a supportive enabling environment is not a trivial task, as it frequently requires facing vested interests and, in some low and middle income settings, also overcoming technical limitations. For example, government attempts to introduce mandatory data reporting to private bureaus may face opposition from powerful incumbents which may not want to share information on their clientele. Private bureau legislation may also be blocked in legislative bodies due to concerns over data secrecy. (By way of example, it has taken some 10 years to make substantive progress in establishing a credit bureau in Vietnam). Strengthening collateral regimes may be hindered over concerns that debtors may become unprotected. Attempts to improve competition in banking systems may also be hindered by incumbents and concerns that the system is already overbanked. These constraints may delay significantly the pace of reform in some countries.

It must also be recognized that even an effective enabling environment may not be able to ensure access to some target groups, especially start-ups and very young firms without sufficient credit history or collateral. Young and small firms may have sound business plans and promising growth potential, but they may not have a sufficient credit history to be captured by credit reporting systems, or lenders may have lingering doubts about the quality of their collateral. Many intervention efforts around from around the world have been targeted at specific sectors – France, Finland, Australia and Malaysia, for example, have a range of programmes in place to support companies operating at the cutting edge of their particular sector (i.e. more innovative businesses that may not be able to access support for new ideas); South Africa has a 'black empowerment' risk sharing facility in place to target qualifying entrepreneurs, and various other mechanisms are in place to target groups such as women-owned businesses (Nigeria), energy efficient/environmentally sound SME projects (Russia, El Salvador) and newly created SMEs (Ethiopia, through a government sponsored business plan competition whose prizes help to facilitate access to finance from the private sector).

4.2 Addressing Other Barriers to Growth

Deficiencies in the enabling environment and residual market failures have also motivated other forms of interventions in the SME Finance space. Partial Credit Guarantee or Risk Sharing Schemes (PCGs), for example, are operated by a large number of countries around the world. In developed countries, such schemes have been operational for over four decades while their usage in developing countries is fairly recent. In the case of PCG schemes, loans offered by a (private sector) financial institution to the borrower are partly guaranteed by a third party (typically, a government agency) subject to the lender paying the guarantor a fee (which would usually be passed on to the borrower). Such schemes are designed to cover instances where either the borrowing entity does not have sufficient collateral (for example, in Holland) or where for other reasons the project is deemed to be high risk. The level of guarantee coverage varies from scheme to scheme, but most provide coverage of around 50% (albeit one scheme operated in India offers coverage of 85% of the face value of the credit facility).

One variation on the PCG theme that has been seen in more recent times is the creation of 'Crisis Support Funds' to help viable SMEs weather the worst effects of the recent global financial crisis. Turkey, for example, has put in place a fund (until the middle of 2011) to provide credit guarantee support (65% coverage) to banks to ensure that a steady supply of financing to the SME sector is maintained, while Malaysia has developed a fund (channeled through nominated intermediaries) to provide direct lending support to viable SMEs that might be experiencing temporary difficulties because of the crisis. Other countries (Canada, Chile, and South Korea) also scaled up their guarantee schemes in various ways to bolster the SME sector in the face of the economic crisis.

[48] Beck and De la Torre (2006).

PCGs are considered to be one of the most market-friendly types of interventions. Unlike other types of interventions, they may generate fewer distortions in the credit market and are more consistent with a well functioning banking system.[48] PCGs may prove an effective vehicle for reaching underserved groups such as start-ups and small firms. They may also generate positive externalities by encouraging banks to get into the SME market, and improve their lending technologies and risk management systems.

At the same time, PCG schemes may add limited value and prove costly when they are not well designed. PCGs differ significantly in fundamental design features, such as eligibility criteria, fees, coverage ratios, and payment rules. Loose criteria, low fees, and overly generous coverage ratios and payment rules may result in the provision of guarantees to enterprises that would have obtained credit anyway. They may also result in financial imbalances requiring large and recurrent Government contributions.

Direct lending to SMEs can take several forms, including provision of lines of credit to financial institutions and co-financing facilities, and may be subsidized or not. Some governments impose quotas on bank lending to SMEs or offer lines of credit through SME agencies or development banks to retail banks for SME lending. (By way of example, the SME sector in India is designated a ‘priority’, and banks are required to ensure that a certain percentage of their lending portfolio is directed to companies within these sectors; similarly, the Philippine government has put in place a ‘Magna Carta’ for the SME sector which serves both to define what constitutes a SME while at the same time again imposing on the banking sector certain minimum requirements as to the volume of lending to such entities).

International organizations also offer concessional loans to governments to support bank lending to SMEs, usually channeled through an SME agency or state bank. There is evidence that some of these programs have alleviated credit constraints, but there are also unsuccessful experiments, and the impact of many of these interventions has not been properly evaluated[49]. Research has shown, however, that some of these programs can prove costly and be politically captured, especially when they involve subsidies.[50] Overall, there is insufficient research on the impact of the variety of directed lending programs that have been implemented worldwide. This is especially the case of programs that entail lending quotas at below market rates, and where there is a less transparent element of cross-subsidization from non-favored sectors.

State owned financial institutions have also been used in many countries to serve the SME sector. Survey work conducted by the World Bank shows that state owned banks have played an important role in SME finance in many countries.[51] These

[49] The current work being done by IFC on behalf of the G20 leaders has demonstrated that one of the biggest problems with any intervention is determining and measuring the impact of different policies and interventions.
[50] Adams, Graham and Von Pischke (1984).
[51] Beck, Demirguc-Kunt, and Peria (2008) and Rocha, Farazi, Khouri, and Pearce (2010).

have included commercial banks, development banks, and banks specialized in SME Finance. In contrast with credit guarantee schemes, however, the risks associated with more direct interventions are higher. The same survey work also shows that state banks have on average weaker risk management systems.[52] Empirical research shows that state banks in developing countries have not performed well in general, and that their lending is significantly correlated with the election cycle.[53] There are many cases of state banks that are subject to systematic political interference and that have to be recurrently recapitalized at a high cost to taxpayers. (Note, however, that some countries seem to have been able to introduce reasonable mandates and governance structures to state banks,[54] while others have managed to play an important counter-cyclical role in the recent financial crisis).

Initiatives to focus on the need for capacity building at the SME level have been undertaken by the private sector alone, as well through multi-lateral supported programmes that have capacity building components at the firm level. A number of schemes are in place throughout the world (Kenya and Sierra Leone are good examples from the African continent) to set up equity funds dedicated to SME sector investment; other countries have gone further by establishing SME dedicated stock exchanges (South Korea) and, as a support function for these activities, a SME dedicated rating agency (India).

4.3 Other Initiatives

The importance of supporting the SME sector to ensure that it continues to drive economic growth is emphasized by a wide range of different initiatives. Other interesting examples worthy of note include the following:

- A Chilean state-owned bank that has created a special SME banking platform, with technology, people and methodologies all developed exclusively to focus on the SME sector;
- A Mexican development bank which has created a programme around supply chain relationships, which allows SME sector clients to access funding based on the credit standing of the large lead firms in each particular supply chain;

[52] *Rocha, Farazi, Khouri, and Pearce (2010).*
[53] *Micco, Panizza, and Yañez (2007), Cole (2004), Dinc (2005).*

5. Conclusion

This paper is built around a proposition that the SME sector will thrive (and thus generate greater employment opportunity) in an environment that supports business growth, where the regulatory regime is transparent and decisions are made in a consistent fashion (and not on an ad hoc basis) and where the physical infrastructure (road and rail networks, power and telecoms connections) is adequate to facilitate trade and commerce (rather than impeding it). Furthermore, the paper supposes that a key impediment to SME sector development is the lack of access to external finance[55], since there is a limit to how far firms can grow simply by reinvesting earnings and tapping into their owners' personal funds.

A range of interventions have been considered. At the macro level, this means that government is responsible for ensuring that the right financial infrastructure (credit bureaus, collateral registries) and the appropriate regulatory regimes for the financial sector as a whole (for those financial products, such as leasing, that require them) are in place. However, state intervention can also take other forms - support funds for lending and venture capital investments, PCGs, state-owned banks, targeted lending - which aim to fill gaps where private sector institutions are unwilling or unable to take on the risks involved.

The role of private sector financial institutions, at the micro level, will in large part be influenced by the conditions of the playing field that has been prepared for them by the authorities. Once suitable conditions have been created, financial institutions need to understand that working with the SME sector demands different skills and approaches to those used when working with either the corporate or retail segments. In particular, banks should consider the following:

- Strategic focus and commitment to the sector;
- Clear understanding of the target market;
- Differentiated products and delivery channels, designed to take into account the bank's chosen target group(s);
- Credit processes that take into account the peculiarities of the SME customer;
- Use of technology to ensure maximum efficiency in service delivery and to collect information in standardized formats for credit decision making and marketing purposes;
- Understanding of the skill sets required in each role to make sure the right people are in place;

Interventions at the SME level, to build internal management capacity and skills, tend to be harder to organize in such a way that they reach a critical mass of beneficiaries. Some successes in this area are noted when the private sector venture capital becomes involved (for example, by introducing additional expertise and capacity to

54 Rudolph (2009)
55 While the focus here has been on finance in the context of lending, the term should also be understood more broadly

bolster a company's management in certain areas) but such cases tend to be rare and are of course more to be found at larger end of the SME scale. Many banks also make a play in this area – albeit more as a marketing strategy than from any other motive – by organizing seminars on topics of interest to SMEs both for existing and potential customers. One regional Russian bank has created for itself a very distinct profile as 'the bank for SMEs' by doing exactly this and by launching alongside its general 'advisory' offering a competition for 'SME of the year', with part of the prize consisting of (free of charge) access to consultancy advice in areas of interest to the winner.

There is no one 'magic bullet' that will ensure growth in a country's SME sector. This paper has attempted to cast light on a number of the issues that are seen as important in creating an environment conducive to SME sector growth, and has emphasized in particular the need for government and the private sector to come together to address the financing needs that so often suppress the creativity and innovation characteristically seen amongst SMEs from around the world.

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The role of SMEs in employment creation and economic growth: lessons from other countries

A Response to Neil Ramsden,
by
Herbert Jauch, Labour Researcher & Educator

1. Introduction

Mr Ramsden's paper contains several interesting observations to which I will respond selectively. The focus will be on those aspects that seem most relevant to Namibian SMEs based on the available literature on the subject. I will make particular reference to Namibian studies carried out a few years ago by the Labour Resource and Research Institute (LaRRI), the Namibia Economic Policy Research Unit (NEPRU) and the Institute for Public Policy Research (IPPR) in collaboration with the Joint Consultative Council (JCC).

Mr Ramsden's paper focuses on the importance of the "business environment" and the support structures that may be needed for SME's to thrive, drawing on international experiences in both industrialised and developing countries. My paper will attempt to point to some interventions that might be particularly relevant to Namibia. I will also allude to possible limitations for SME development arising from free trade arrangements and liberal economic policies.

My paper will pay particular attention to the potential for job creation and the quality of jobs in the SME sector. Due to colonial economic policies that were biased towards larger businesses, Namibia's SME sector (both formal and informal) was very small at independence but has grown substantially since then. This occurred not as a result of deliberate interventions but rather as a result of the inability of the formal sector of the economy to absorb the mostly young, new job seekers who enter the Namibian labour market every year.

Namibia has committed itself to the decent work agenda of the International Labour Organisation (ILO) and many Namibian households rely on a single wage earner for their survival. The quality of jobs is thus a crucial determinant in the struggle to overcome poverty and needs to be included in an analysis of the SME sector in Namibia.

2. Defining SMEs in Namibia

Mr Ramsden points to a broad spectrum of definitions across countries and regions. He cites the example of the European Union (EU) which distinguishes between micro-firms, small- and medium size enterprises. In Namibia, there are several names and definitions given to the SME sector which overlaps to a significant extend with the informal sector. The multitude of definitions should not be regarded as a problem in itself but an indication of the challenges regarding the lack of clarity and consistency faced by all those dealing with the sector. A widely used definition of the SME sector in Namibia is the one of the Ministry of Trade and Industry (MTI) (See table 1 below).

Table 1: MTI's Small Enterprise Definition

Sector	Employment	Turnover (N$)	Capital Employed (N$)
Manufacturing	Fewer than 10 persons	1,000,000	500,000
Service	Fewer than 5 persons	250,000	100,000

Source: LaRRI and NEPRU 2002

This definition of the SME sector has some limitations. Measuring capital investment, as suggested by the above definition is problematic because of the difficulty of achieving accurate measurement and also because of the impact of inflation. The employee characteristic is simple to verify and remains a valid criteria. The LaRRI/ NEPRU study of 2002 found that about 68% of the SME businesses were small and employed less than three persons. Fifty-eight (58) percent of these businesses were realising a turnover of less than N$ 35,000 per annum whilst only 6% of the businesses had a turnover of over N$ 250,000 (LaRRI 2002:13-14).

A SME baseline study conducted by the MTI in the Erongo and Otjozodjupa regions suggested that the definition be reviewed in light of the findings that the average size of employees in the SMEs was only 2.2 employees (MTI, 1998b: 54). In Northern Namibia, 58% of the enterprises had monthly turnovers below N$ 1000, and 84% had turnovers below N$ 5000. The data collected also showed that 78% of businesses were very small and employed less than three persons (MTI, 1998a, quoted in LaRRI 2002: 14-15).

The MTI study suggested that the current definition be reviewed in light of international definitions on the SME sector in order to allow comparisons. It concluded that the majority of the enterprises will remain micro-enterprises with the exception of a few that might transform themselves into small or ultimately large businesses (ibid: 15).

Earlier studies found that Namibia's SME sector was engaged in a whole range of activities ranging from:

- subsistence farming;
- crafts (including: woodwork, pottery, handicraft, basketry, jewellery-making, leatherworking, weaving, sewing, and furniture-making);
- small scale manufacturing (including: bread making, tailoring, food catering, candle making, and confectionery);

- small-scale mining;
- small-scale construction (including: building, brick-making, plumbing, welding, carpentry, and electricity);
- informal services (including: transport, repairs of cars, shoes, electric household appliances, gardening, domestic work, and hoe polishing); and
- informal trade (including: rural information markets (Cuca shops), urban information markets (e.g. Katutura "single quarters"), informal cross-border trade (e.g. along the Namibian-Angolan border), informal meat markets ("bushmarkets" in rural and urban areas), informal mahangu marketing, and informal/illegal diamond smuggling. (van der Linden, 1993: 4).

3. Formal or informal?

The difficulties in defining SMEs are further compounded by the blurred line that exists between the formal and informal economy. Arnold et al (2005: i-ii) found that only the larger SMEs tended to be formal while the jobs created in SMEs were largely informal. A LaRRI study into Namibia's informal economy pointed to the difficulties in defining it:

"Defining or describing the informal economy is considered one of the toughest jobs and distinguishing it from the formal sector is even harder (Van der Linden, 1993). What might be considered informal in one country might not apply in another. Some have defined it by using the poverty approach, while others use the size of the business and the number of employees. Some use unregistered status and inability to pay tax as guidelines to define the informal economy.

The ILO defines the informal sector as:
Very small scale units producing and distributing goods and services, and consisting largely of independent, self-employed producers in urban areas of developing countries, some of whom also employ family labour and/or a few hired workers or apprentices; which operate with very little capital, or none at all; which utilise a low level of technology and skills; and which generally provide very low irregular incomes and highly unstable employment to those who work in it (ILO 1991).

Due to the many facets of the informal economy, the best approach is to have country specific definitions. The Namibia Informal Economy Survey (2001) defines the informal economy using the 1993 ILO International Conference of Labour Statistician (ICLS-93):
The informal economy units/enterprises typically operates at low level organisation, with little or no division between labour and capital as factors of production, expenditure for production is often indistinguishable from household expenditure. Similarly, capital goods such as buildings or vehicles may be used indistinguishably for business and household purposes. Labour relations where they exist are based mostly on casual employment, kinship or personal and social relations rather than contractual arrangements with formal guarantees. Furthermore, these units are not registered under specific forms of national legislation. There is no complete set of accounts maintained (MOL 2001: 5)." (Mwilima 2006: 2-3)

4. Employment creation

Mr Ramsden pointed out that SMEs account for around 45% of formal sector workers in developing countries and contribute about 24% of GDP. In Namibia, the SME contribution seems to be lower but the lack of up-to-date statistics makes an accurate assessment difficult. Arnold et al (2005) put the SME contribution at 20% of employment and 12% of GDP.

An analysis of the official employment and unemployment figures between 1997 and 2008 reveals Namibia's huge crisis of mass unemployment as reflected in tables 2 and 3 below. In 2000, the overall unemployment rate (according to the broad definition) stood at 33, 8% and increased to 36,7% in 2004 and further to a record 51,2% in 2008. The situation for women and young Namibians was far worse with youth unemployment reaching around 75% in 2008.

Table 2: Employment by sector (1997- 2008)

Industry	1997		2004		2008	
	No.	%	No.	%	No.	%
Agriculture (commercial & communal)	146 899	36.6	102 636	26.6	52 788	15.9
Fishing	6 771	1.7	12 720	3.3	1 318	0.4
Mining & quarrying	6 592	1.6	7 563	2.0	8 894	2.7
Manufacturing	25 983	6.5	25,755	6.2	20 961	6.3
Electricity, gas & water supply	4 576	1.1	6 151	1.6	5 384	1.6
Construction	19 801	4.9	19,605	5.1	23 316	7.0
Wholesale & retail trade, repair of motor vehicles, hotels and restaurants	36 803	9.1	67 027	17.4	61 453	18.5
Transport, storage & communication	13 480	3.4	15 861	4.1	15,598	4.7
Finance, real estate and business services	28 061	6.8	16 956	4.4	23 589	7.2
Government service including administration, defence, education, health, social work and social security	56 974	14.2	75 863	19.6	70 166	21.2
Other community, social & personal services (including domestic work)	53 065	13.1	36 713	9.5	47 367	14.3
Other	2 135	0.6	479	0.1	584	0.2
TOTAL	**401 203**	**100**	**385 329**	**100**	**331 444**	**100**

Sources: Ministry of Labour 2001, 2006 and 2009 (unpublished)

Table 3: Unemployment trends (1997-2008)

	1997:	2000	2004	2008
Overall Unemployment:	34,5%	:33,8%	:36,7%	:51,2%
Unemployment amongst women	0,4%	39%	43,4%	58,4%
Unemployment amongst youth (15-24 years)	58%	67%	61%	75%

Sources: Ministry of Labour 2001, 2006 and 2009 (unpublished)

These figures reveal that Namibia's jobs are shrinking with the overall number of formal sector jobs being reduced by almost 20% from 401 203 in 1997 to 331 444 in 2008. During that period an estimated 20 000 to 25 000 new, young job seekers entered the labour market every year. This scenario is made worse by the fact that many Namibian households (close to 50%) depend on one main wage earner and thus unemployment has an immediate effect on household survival.

As a result, many people are forced to make ends meet in the informal economy. Although informal employment in Namibia might not be as high as in other African countries, the informal economy is growing fast – not by choice but as a result of the formal economy's inability to create sufficient employment opportunities. Thus the task of creating a substantial number of jobs and over time turning them into decent, formal employment opportunities is one of the most critical challenges in Namibia today.

5. Quality of jobs

A LaRRI study (2002: 6) found that most SME workers did not join the sector by choice but rather because there were no other employment options available. The duration of employment varied greatly between a few months and ten years or more. The average duration of employment was 1 - 2 years and the vast majority of SME workers earned less than N$ 1 000,- per month. Women were concentrated in the lowest salary scales with over half earning less than N$ 500,- per month. SME workers received their payment regularly but enjoyed only few benefits and even the compulsory benefits such as annual leave and membership with the Social Security Commission were only enjoyed by a minority. Almost 90% of SME workers were are also not covered by any pension, scheme, medical aid or any other form of insurance.

Few SME workers had other sources of income and most had to rely on their salary as the sole means of survival. Most had to support 1 - 6 people, which means that the SME salaries were a basic means of household survival.

Most SME workers considered their workplaces as safe although there was a difference between the different SME clusters. Most concerns about workplace safety were raised in the construction industry.

Despite the relatively low salaries and the absence of fringe benefits, most SME workers were generally satisfied with their current job. Likewise, the relationship with the business owner was rated positively but because of the low salaries and the lack of benefits, most SME workers would prefer to work in the public sector or in a large private firm. In other words, Namibian SME workers were in the sector because of a lack of alternative employment (loc. cit.).

A subsequent LaRRI study into the informal economy confirmed many of these trends. In 2006, business operators earned monthly average incomes of about N$ 1450 while informal economy workers earned monthly average incomes of N$ 375 with the majority of the workers earning below the average incomes. A gender analysis of incomes revealed that female workers earned lower wages than men although they had higher educational qualifications (Mwilima 2006: vii).

The working conditions in the informal economy were characterised by long working hours, low salaries, lack of employment contracts, lack of benefits such as medical aid and paid maternity leave. Overtime payments as prescribed in the Namibian Labour Act hardly occurred. Few workers were registered with the social security commission, thus making them more vulnerable during times of sickness and pregnancy. However, more than half of the operators provided benefits to their workers in the form of food, accommodation, transport, annual leave and assistance during times of difficulty (loc.cit).

Generally workers in the SME sector seem to have relatively few concerns about their workplace safety. However, the provision of safety equipment at the workplace was found to be inadequate and there are far too few labour inspectors to ensure adherence to basic health and safety standards as well as the basic provisions of the Labour Act and the Social Security Act (LaRRI and NEPRU 2002).

These findings show that most employees in Namibia's SMEs fall into the category of the "working poor" who struggle to meet even their basic needs despite being in full-time employment. The legally binding minimum conditions of employment as set out in the Labour Act tend to be ignored in SMEs. This was also found to be the case in the construction industry where a survey commissioned by the Construction Industries Federation (CIF) revealed that 60% of SMEs paid their staff below the legally required minimum wage (Consult Buro 2007).

6. SME challenges

Mr Ramsden outlined several challenges experienced by SMEs in developing countries, including cumbersome business regulations, insufficient infrastructure, corruption, access to finance and management capacity (i.e. the need for skills across a wide range of disciplines, many of which are specialised/technical). He also pointed out that the smallest firms are most severely affected by these constraints. Although SMEs often start with internal sources of funding (such as savings) they tend to require external funding as they grow. Access to such funding was mentioned as a major obstacle to SME growth and development. How does this compare to the empirical evidence from Namibia?

The LaRRI-NEPRU study of 2002 found that the majority of SMEs had a fixed telephone and/or a cellular phone. Even amongst SMEs with turnovers below N$1,300 per month, the prevalence of fixed telephones was higher than 50%. About three in four SMEs were registered with a ministry or a local municipality but there was a strong relationship between registration of the businesses and turnover. The average monthly turnover for registered SMEs was N$ 13 900 compared to N$2,100 in the case of unregistered ones. The larger SMEs were also those operating a bank account.

Only one out of 10 SMEs enjoyed any credit facilities provided for by their suppliers and less than 15% of businesses had taken up loans during the past 12 months. On the other hand, 44% of the SMEs surveyed had invested during the last 12 months with an average amount of N$9,700.

The LaRRI-NEPRU study found that financial support was by far the most needed support by SMEs but a subsequent study by Arnold et al in 2005 found that SMEs not only rely on their own financial resources but also “don’t even want credit as they perceive it as negative”. Perhaps even more surprising, the latter study found that the majority of Namibian SMEs did not want to use the existing business support services in future (Arnold et al 2005: ii).

Skills development for SMEs seems to be a widespread phenomenon in Namibia. LaRRI and NEPRU found that over 80% of all SME owners had attended both a management and a technical training course during the past 12 months. For the businesses with a monthly turnover below N$1,300 the figure was over 90%.

These empirical findings suggest that the challenges facing SMEs in Namibia only partly conform with those in other developing countries. Challenges like unreliable electricity supply and widespread corruption seem to be less of a problem in Namibia than elsewhere. However, many of the existing business support services in Namibia seem to be of little relevance to SMEs. This however, may have changed in recent years as the studies referred to in this paper were already carried out in 2002 and 2004 respectively.

7. SME support

Mr Ramsden's paper alludes to various support strategies needed to effect SME growth and development. These include financial services that will meet SME needs, effective collateral regimes that will contribute to banks lending to and supporting SMEs more willingly and a supportive legal framework for SMEs. An interesting example cited is China which works on the use of movable collateral registries to overcome the challenge of collateral experienced by SMEs.

Some of these suggestions are echoed in the Namibian studies. Arnold et al (2005: iii) suggest the introduction of special financial services for small businesses and the systematic promotion of linkages between larger private firms of the SMEs as such linkages hardly exist. The authors also allude to the need to undertake regular SME development and impact assessments to continuously assess the effectiveness of the support measures taken. This is certainly a key challenge in Namibia where comprehensive and reliable data are hard to come by and often already outdated by the time the reports are released.

8. Creating an enabling environment

Mr Ramsden's proposal for the creation of an enabling environment for SMEs is based on market-friendly, supply-side interventions. His paper does not provide an analysis of how liberalised economies and fierce competition may undermine the development and growth of SMEs. The "South-East Asian Tigers", for example, advanced their economic growth on the basis of state interventions in the economy, coupled with systematic support and protection for local companies. This only changed gradually once local companies (many of which started out as SMEs) had grown and were firmly established, able to survive international competition.

Such an approach may hold relevant lessons for Namibia since our markets are dominated by imports in virtually all sectors. Retail, banking, mining and fishing, for example, are almost completely dominated by transnational corporations (TNCs). Namibia's manufacturing sector remained very small despite the various attempts to kick-start local processing through Export Processing Zones (EPZs) and other incentives for (mostly foreign) investors.

The potentially damaging impact of free trade arrangements and foreign competition in Namibia was highlighted by two specific cases in recent years. One was the proposed free trade agreement between the EU and the ACP countries and the other one was the impact of Chinese retailers, particularly in Northern Namibia. African trade analysts such as Wallie Roux, Yash Tandon and Dot Keet as well as our Minster of Trade and Industry, Dr Hage Geingob, have repeatedly alluded to the dangers of the proposed Economic Partnership Agreements (EPAs) for development prospects in general and Africa's emerging industries in particular. In his address to the National Assembly on 19 May 2010, Dr Geingob pointed out that the EPAs in their current form would make it impossible for Namibia to use export taxes on raw materials as an incentive for value addition inside the country. Likewise Namibia would have to abandon its current system of infant industry protection and thus the proposed EPAs would undermine Namibia's industrialisation efforts (Windhoek Observer, 22-28 May 2010). This would certainly affect the prospects of SME growth and development and thus the Namibian government's resistance against the interim EPAs was an important step towards negotiating a more conducive trade agreement that will be more conducive to the developmental needs of African countries.

Liberal access for imported goods and services to Namibian markets is likely to undermine SME chances of success. A recent study into Chinese investments in Namibia, for example, found that the welcoming attitude towards Chinese investments that seemed prevalent amongst Namibian politicians and government officials was not shared by Namibia's small traders. They pointed out that Chinese businesses were now even threatening the small subsistence home industries trading in "kapana" (roasted meat) and "fat cakes". A local businessman, John Endjala, was not happy that government failed to protect local people from unfair competition: "Threats from the Chinese are harming our businesses – they are also going into the kapana business and competing with our people because they know how to do it. We cannot go against the Chinese because they have been welcomed here by our government... Most of them employ locals to do the meat roasting and selling. Chinese traders in Windhoek, particularly at the popular Chinatown, have been accused of paying their employees paltry salaries of as low as N$ 300 … After having overtaken the construction and other established businesses they are now competing against our mothers who are selling kapana and they are even speculating in bread making" (Informante, 7 June 2007, quoted in Jauch and Sakaria 2009: 19).

A LaRRI study pointed out that in 2008, a group of indigenous business people in Northern Namibia had publicly voiced their outrage over what they termed unfair competition from Chinese traders. An "Anti-Chinese Group" was formed and called on government to protect local businesses. They pointed out that the Chinese merchants have an advantage because they source their goods directly from China. The group demanded that Chinese merchants should be restricted to operating warehouses from where local businesses could buy. The group's chairman Epafras Mukwiilongo stated that:

"Some of these people (Chinese) get subsidies from their government, they can afford to sell their products at a very low price and we don't have any type of protection. Chinese investors are taking all the business opportunities from the local people. We understand that we have a free market economy, that we have to compete, but what is happening is robbery, it is not free and fair competition... The government is telling the youth that they should go and establish SMEs, but how does government expect this people to compete against already skilled and experience business people if they are not given any type of protection?" (quoted in Jauch and Sakaria 2009: 19-20)

On a more positive note, the introduction of quotas for retailers (as happened in recent years) to source a certain percentage of their goods locally may hold great benefits for Namibian producers and could be targeted at the SME sector. Linkages between local producers to retailers through the creation of local supply chains could well be achieved through such interventions which target the supply and demand side at the same time. Likewise, government procurement like army and school uniforms, school furniture etc. could be deliberately sourced from local SMEs as a deliberate developmental intervention.

Finally, the introduction of a national Basic Income Grant (BIG) is likely to have a positive effect on the development of small businesses that target local markets. The BIG pilot project in Otjivero has shown how the small cash injection into a local economy created a local market and consequently resulted in the emergence of a variety of new, small businesses such as bakeries, dress-makers, shoe repairs, barber shops, brick makers etc.

9. Conclusion

There is no doubt that the SME sector has a large potential for employment creation which is desperately needed in Namibia. The Namibian government's ambitious target of transforming the SME sector into the lead sector of the economy may not have been achieved yet but its potential for employment creation seems significantly larger than that of Namibia's large business sector due to SMEs' labour-intensive nature and their use of local resources. The SME sector was estimated to grow by about 16 500 jobs per year compared to only 3 000 - 4 000 jobs in the larger business sector (LaRRI and NEPRU 2002). However, these figures are outdated and there is an urgent need for accurate data as well as a continuous assessment and evaluation of the sector. This should include an analysis of the effectiveness of support services available to SMEs.

Incentives to entice small businesses to register with a local, regional or national authority should be considered as a possible strategy to obtain a fairly good picture of the size of the SME sector. SMEs are likely to be willing to register if there are benefits to be gained. Incentives for voluntary SME registration could include inter alia, access to free management and technical courses.

Provided that the SME sector receives adequate support and protection, its impact on unemployment could be far more significant than that derived of foreign investment in Namibia. The mining sector, for example, which accounted for the bulk of Namibia's foreign direct investment (FDI) over the years, created less than 10

000 jobs. Although employment in the SME sector seems to usually be of a short to medium term duration, there are a number of positive trends such as the friendly and conducive employer – employee relationship that prevails in the sector. However, key labour challenges such as low salaries and lack of benefits as well as gender discrimination urgently need to be addressed to avoid the SME sector becoming a gathering of the working poor.

The dilemma posed by low earnings is exacerbated by the fact that the majority of workers in the sector do not have any other source of secondary income. Improved conditions of employment should be seen as being in the interests of not only SME workers but also SME owners, service providers and government because improved conditions will help to raise living standards, productivity, and demand for local goods. This should thus be a central element of an SME development strategy.

The positive employee-employer relationship could become an incentive for workers to stay in the SME sector if this is coupled with improved conditions of employment and ongoing training. It might be worthwhile exploring the link between more systematic training for SME workers, increased output and better working conditions which in turn would encourage workers to stay.

There are several Namibian organisations that provide technical, managerial and other forms of assistance to SMEs such as the Joint Consultative Council (JCC) and SME Compete. They are well-placed to work with government and SMEs to deal with the operational challenges facing small businesses, several of which were mentioned in Mr Ramsden’s paper. Government, however, still has a larger responsibility and role to play in regulating the macro-economic environment. The issues of local value-addition and unfair competition faced by SMEs require particular attention. The policy space must be kept open for developmental interventions by the state, including measures to encourage and protect local processing, establishing linkages between state institutions and SME suppliers as well as SME linkages with larger private firms.

During the colonial regime, the growth and development of the SME sector was deliberately hampered and competition from South African companies (such as retail chains) posed a major threat for Namibian SMEs. Today, Chinese, European and other imports have added pressure on SMEs. As a policy recommendation, government should guard against the creation of an environment in which small operators are pushed out of business by transnational corporations who tend to repatriate their profits. Nurturing small operators is desirable in that they are labour-intensive and thus may create and sustain more jobs than larger business sector.

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SME financing: strategies for Namibia

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Abstract

An attempt to provide specific solutions to address the apparent SME funding crisis would be deemed to be a government intervention. This intervention is intended to specifically benefit the SME sector of the economy and would therefore be determined to be a selective intervention.

Interventions are a response by government to both market and government failures. Economic theory recognises that failures occur, and that at times they occur because of government, sometimes despite government, and sometimes simply due to the inability of the market to develop the requisite mechanisms for the matching of supply and demand so that transaction occurs, a market failure.

In the event of market failure, certain perspectives argue that government will as likely fail in its efforts to correct the market failure, as government at best suffers the same constraints as the market itself does in respect of market knowledge. Therefore government needs to be sure and have planned well, and carefully assessed the market and the failure, prior to intervening.

The starting point is to understand the underlying economic theory, in this case The Theory of the Firm, and how government impacts on the Firm in the context of this basic economic theory. Similarly, Burch's Entrepreneurship Continuum is discussed and further reviewed in the context of a desktop review of current entrepreneur research, and is shown to impact on the selection of interventions, and highlights that an entrepreneur is not necessarily an entrepreneur.

A broader range of desktop research looks at a range of factors that would impact on the efficacy of any intervention by government, to address the apparent SME funding crisis. This includes data that highlights the role of certain entrepreneur types in economic development and job creation and dispels certain of the myths that have developed around the area of SME development. All factors highlight, as part of the broader discussion, the importance of finance on the start-up and growth of SMEs.

In the final section specific interventions that may be of use to Namibia are proposed in the context of the underlying theories and desktop research detailed in the earlier part of this document.

1. Introduction and background

The caveat to this paper is that we cannot always replicate what we see elsewhere, and therefore recommendations must be treated with care and carefully assessed with regard to their local applicability and relevance.

The determination of the need for any type of government intervention is generally indicative that a problem exists within the market. In order to assist in understanding the problem, economic theory attempts to pinpoint the source of the failure. Governments generally postulate that interventions are required due to a failure within the free market system, otherwise known as a market failure (Stiglitz 1989:197). Stiglitz (1989:202) further suggests that not all market failures can be successfully addressed through government interventions, as governments themselves are subject to the same constraints, such as insufficient information, and therefore governments are as likely to fail as the private sector is (Parkin, 1996:426). Hosseini (1999:20) and Stiglitz (1989:197) also state that albeit that market failures occur in developed and developing countries, they occur more frequently in developing countries.

It is important to understand, that the assumption is that market failures occur within a free market system. A free market is defined as a market free of government intervention and regulation, where the factors of production are owned and controlled by the private sector. This is an ideal which is strived for and achieved by different governments at differing levels. In a free market the buyers and sellers freely buy, sell and compete with one another. As a group, they will use their aggregated supply and demand capacities and constraints to set the equilibrium price of the goods being traded. Therefore, all markets cannot be defined as free markets in the broader context and consequently the application of interventions may not necessarily achieve the same outcomes in every market, due to the variance in market freeness (New Zealand, Online 15 April 2004:10; Parkin, 1996:426; Mohr & Fourie, 1995:46).

Governments use a variety of economic analysis tools, to inform themselves while defining public policy, in an attempt to correct the market failure. An example of market failure, in the context of this study, could be the apparent lack of appetite commercial banks have for lending to SMEs, in particular to start-ups.

Market failure is often seen as a justification for government interventions by the incumbent governing authorities. On the other hand, supporters of a free market environment believe that government interventions are often the root cause of market failure to begin with (Mitchell, 2006:57).

The second source of failure is government failure. Government failure could arise as a direct result of attempts by government to correct market failure, and in the process they could contribute to market failure. This, in the context of this study, could be over-regulation by government, which would stifle SME start-up and growth rates (Montgomery & Bean, 1999:403). In certain instances, government failure can be of such enormous impact as to override the impact of market failure, to the extent that the market is unworkable (Hosseini, 1999:30). Furthermore, interventions in separate sectors could create unexpected conflict with indeterminate consequences between interventions. An example again could be interventions aimed at assisting SMEs access finance, which in turn conflicts with interventions aimed specifically at banks, and which leaves banks in a situation that they are forced to break the law whichever way they turn.

Continuing with the example used, the banks may refuse to do large scale SME lending because they do not know how to assess the risk profiles of SMEs, leading to a market failure. However, the fact that banks do not wish to lend money to SMEs could be attributed to the fact that government intervention on maximum interest rates chargeable, creates a limitation that inhibits the free market system of supply and demand. This would occur because the banks are now unable to set interest rates at such a level as to be commensurate with the risk associated with SME lending. This would be a government failure. In both cases, it results in a contraction of the supply, in this case of finance (Montgomery & Bean, 1999:404).

All governments face the challenge of unemployment and low GDP growth from time to time, to varying degrees, and therefore, governments are always seeking new and effective solutions to this recurring problem. In an attempt to reduce unemployment and increase GDP growth, these governments affect a wide range of different interventions. The current trend, among developed and developing countries, is to attempt to boost the SME sector as a solution to these problems (Smorfitt; 2009:2; Thailand, Online 15 April 2004:1).

All government interventions can be classified as either functional or selective interventions (Smorfitt, 2009:1; Unctad, Online, 8 November 2008:3; Wint, 1998:281). Functional interventions are generic interventions that impact on all Firms within the economy equally, while selective interventions are aimed at providing specific relief or assistance to a particular segment of the economy, with the intent of improving the economy for all (Smorfitt, 2009:1; Unctad, Online, 8 November 2008:3; Wint 1998:28). In this case, SME specific interventions would be considered to be selective functions.

A literature review of international government interventions highlighted that developed countries were biased towards selective interventions, while there was a greater bias towards functional interventions among developing countries. However, all countries made use of both functional and selective interventions (Smorfitt, 2009:85).

In the introduction, we have reviewed the basic principles surrounding interventions by governments. While there are arguments for and against governments intervening, every government intervenes in some way. The important issue to remember when designing interventions is to ensure that one intervention does not unintentionally interfere with another. Similarly, interventions must be carefully assessed to ensure that there are no unexpected outcomes, as intervention failures have to be paid by the taxpayer at the end of the day and are counter-productive to government's role of improving the prosperity of all its citizens (Parkin, 1996:426).In the next section the issues to be considered in designing interventions, specifically SME finance interventions, will be considered.

2. Considerations for designing SME finance interventions

In this section, we will review the various issues which must be taken into consideration in planning interventions for SME finance.

As the firm is the vehicle which economists suggest is required for matching demand to supply, the starting point for our deliberations is the Theory of the firm. A country requires production from its citizens in order to stimulate the economy to generate capital resources and jobs. The Theory of the firm defines the relationship between the various factors of production, and explains the role of the firm.

2.1 Theory of the firm

The Knightian approach suggests that the firm is entrepreneurial in nature, and creates markets through specific decision-making processes by the entrepreneur under conditions of uncertainty (Boudreaux & Holcombe, 1989:147; Smorfitt, 2009:16).

The Knightian approach takes specific cognisance of the impact of the entrepreneur during the start-up phase, when the impact of the entrepreneur is at its highest (Dew et al, 2008:38; Smorfitt, 2009:17) but has been superceded by the Behavioural Theory of the firm, which considers every firm to be heterogeneous and further suggests that new markets and new businesses have an interdependent relationship which differs from existing businesses in existing markets (Dew et al, 2008:41; Smorfitt, 2009:17).

Salvatore (2000:9) together with Mohr and Fourie (1995:313) suggest that the Theory of the firm states the main objective of the firm is profitability. It can therefore be argued that if seen holistically, government interventions should address all four factors of production, namely capital, land, natural resources, and entrepreneurship, in order to enhance sustainable profitability of SMEs. The points to remember are that government cannot control what natural resources are available, as they either do or do not exist in the country. Government can facilitate, to a certain degree, access to finance, and perhaps to a certain degree can provide capital in the form of grants and loans where appropriate, or assist in the formation of capital directly and indirectly.

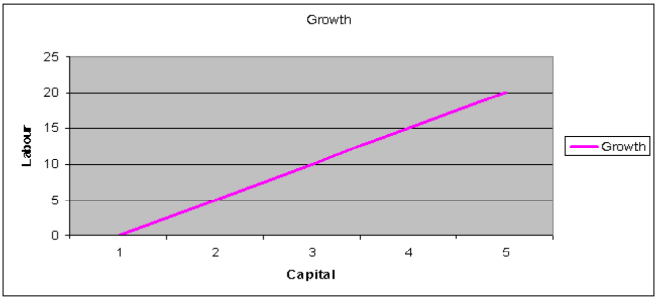
Government is often the largest landowner in any country, and can therefore easily make land available if there is a political will to approach the problem creatively. Government cannot provide entrepreneurship, only the citizens of the country can. Government can help to build a general entrepreneurial culture within the country, and ensure that relevant skills beneficial to entrepreneurs are taught throughout the education system from the first year to the last. Government can control the extended factors, which specifically includes skills and education. Government must ensure that the greater proportion of the country's citizens have the best possible training across all levels of tertiary education, including artisans, technicians and university graduates. This must also be linked to clusters of excellence both within industry and universities from a research perspective (Porter, 1998:186). This is the first of the key issues for governments to take into account in designing their interventions. Strategies to retain these skills must be created, in order to reduce leakage to the developed countries.

This would suggest that government interventions should address all factors of production due to the interrelated nature of the factors of production where possible, and the potential effect of their combination on profitability, thereby helping enterprises to achieve increased profitability, and concomitantly creating economic and job growth which is the output government seeks (Smorfitt, 2009:20).

The entrepreneur can only create demand for labour on an ongoing basis if the business is profitable. Turgot's Law of Diminishing Returns states that a point is reached whereby increasing labour without increasing capital does not lead to an increase in profit maximisation, but rather a decrease. Therefore, the Firm will only increase labour if capital is available to do so, and the output of applying more capital and labour in the firm is, increased profit from increased growth (Mohr, Fourie 1995:313; Smorfitt, 2009:20).

Start-up capital can be sourced externally while growth capital can be sourced externally or from retained profits. Growth can only come from having available working capital. As growth occurs, so too will labour grow within the enterprise. The graph in Figure 1.1 indicates a relationship between capital and labour, with the output being enterprise growth. However it must be noted that while the growth below indicates a linear relationship, this is highly unlikely to be the case. The relationship between capital used and labour growth will vary, between sectors and industries, and according to the position within the industry, product, raw materials and enterprise lifecycle.

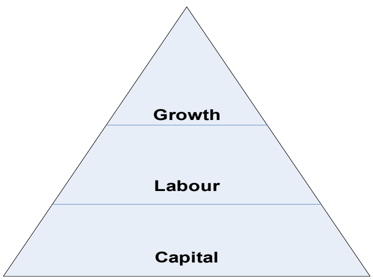
Figure 1.1 – Growth-Capital-Labour relationship graph



The relationship between growth and increasing demand for labour and capital is the second of the key issues for governments to take into account in designing their interventions, as it highlights the importance of ensuring capital availability for businesses.

The model below in Figure 1.2 simply highlights the above relationships. The basis on which growth is predicated is capital and labour. The model clearly indicates that a lack of capital will see no growth in the enterprise, and concomitantly the labour requirements of the enterprise. The same is applicable to labour. If insufficient trained and educated staff is available, availability of capital will still not result in growth of the enterprise. However, as importantly and as is discussed later, this is also based on the assumption that the entrepreneur seeks growth, which is in fact seldom the case. Longitudinal research in the UK shows this to be a mere 6% of those businesses with more than 10 staff (NESTA, 2009:3; UK Department for Business Innovation and Skills, 2009:10).

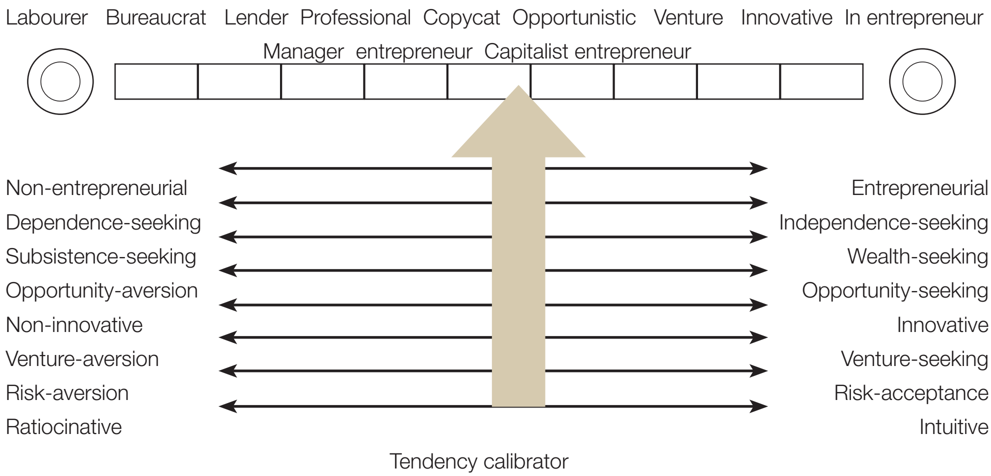
Figure 1.2



2.2 Entrepreneurship continuum

While the Theory of the Firm suggests that all Firms are heterogeneous (Dew et al, 2008:41; Smorfitt, 2009:17), so too are the entrepreneurs themselves.
Burch's continuum (Figure 1.3 below), was an attempt during the early phase of entrepreneurial and small business research, to indicate that different levels of entrepreneurial activity occur, and that each entrepreneur is a unique combination of characteristics at varying levels (Casson & Wadeson, 2007:285; Smorfitt, 2009:18). While the model is perhaps no longer definitive in respect of the current understanding of different entrepreneurial characteristics and types, the underlying principle of each entrepreneur being uniquely positioned along an entrepreneurship continuum remains.

Figure 1.3 – Burch's Entrepreneurship continuum



Current research indicates the presence of survivalist entrepreneurs, salary or income replacement entrepreneurs, lifestyle entrepreneurs, small business manager / franchisees, copycat entrepreneurs, franchisors, inventrepreneurs, serial entrepreneurs, portfolio entrepreneurs, angel funders and venture capitalists. At the one end you have the least entrepreneurial, the survivalist entrepreneurs, who are those individuals who resort to entrepreneurship, because they have no other choice. They are unemployed, often uneducated and unemployable, and entrepreneurship presents their only choice for creating an income. At the other end of the scale, are the venture capitalists who on the other hand are often those entrepreneurs who have harvested sufficient wealth from their own entrepreneurial enterprises, such that they no longer have their own enterprises, but invest solely in other entrepreneurial enterprises (Peters, Frehse & Buhalis, 2009:394; Yenerall, 2008:3;

Bodenhorn, 2008:4; Roberts, 2008:3; Velasco, 2006:1; Maritz, 2006:4; Boyd, 2005:2; Walter, 2005:37; Burch, 2001:13; Hussain, 2000:3; Light and Rosenstein 1995:213). Essentially these entrepreneurs can be categorized into three (3) groups. The first group is comprised of the informal sector survivalist entrepreneurs, the second group is the formal sector lifestyle entrepreneurs, and the third group is the formal sector high growth entrepreneurs.

In the context of this broader continuum, the impact of government interventions would not be equally applicable to all categories of entrepreneurs on the entrepreneurial continuum. Governments would therefore, have to take note of the fact that interventions would impact differently on the different types of entrepreneurs, and different entrepreneurial types will require different interventions (Casson and Wadeson, 2007:285; Smorfitt, 2009:18). Interventions would need to take cognisance of these different types of entrepreneur and their varying characteristics, and is the third of the key issues for governments to take into account in designing their interventions.

2.3 Job creation

An OECD SME related report indicates that SMEs contribute in excess of 55% of GDP and over 65% of total employment in high-income countries. In low-income countries, SMEs and informal enterprises contribute over 60% of GDP and over 70% of total employment, while in middle-income countries they contribute over 95% of total employment and about 70% of GDP. Furthermore, and very importantly, in low-income countries, the contribution of SMEs to employment and GDP is less than that of the informal sector, where the great majority of the poorest of the poor make a subsistence level of living. Therefore policy making in respect of differentiation between informal and formal sectors must be informed, so that policy creates opportunities for the poor to participate in markets and to engage in higher value-adding business activities (2nd OECD Conference 2004:11).

There is a lot of contradictory information on whether SMEs really do create jobs or not. The entrepreneur has become an important focus in recent years. A major reason for this increased interest in SMEs is that SMEs have been perceived to be a major source of job creation. A number of researchers indicated that not only are the numbers of SMEsincreasing internationally, but that SMEs are significant creators of new employment opportunities, underlining their importance in the world economy (Warren and Murphy, 2000:1; Watson, Hogarth-Scott and Wilson, 1998:218; Small Business Profile 2002 – A profile of Small Business in British Columbia, 2002:4). Governments are recognising this increased importance too, and this is reflected in new and changed legislation favouring small and medium businesses, clearly indicating government interventions to stimulate the SME segment of the economy (Warren and Murphy, 2000:2; State of Small Business in South Africa, 1999:11).

Hallberg (2000:4) of the World Bank's International Finance Corporation firstly distinguished micro enterprises as those businesses that trade in the informal sector, and small and medium enterprises as those businesses that trade in the formal sector. Hallberg (2000:5) suggested that more and more SMEs grow into large businesses as the developing economy matures towards a developed economy, rather than as a result of interventions. Hallberg suggested that the evidence points to the fact that within industries, SMEs are in fact less labour intensive than large businesses within a sector, and that the labour intensiveness is related to the industry rather than the size of the business. Hallberg, further stated that developing countries by default will have a greater percentage of SMEs as their economies are young and weak, and that as a country moves towards becoming a developed country, so too does the mix of SMEs to large businesses change in favour of large businesses. Hallberg (2000:6) postulated that SMEs create more jobs because there are more of them. However, she says that if the job destruction rate is factored in, then SMEs do not create more jobs. Therefore, the only way to increase job creation, using SMEs, was to increase the job creation rate by increasing the rate at which SMEs are created, rather than the rate at which micro enterprises are created. Hallberg (2000:10) nonetheless believed that interventions are required, with a bias towards functional interventions in order to grow the rate at which SMEs are established.

However, it is critically important to note that the expectation of SMEs creating jobs is not necessarily correct in the broadest sense of this statement. This is due to the fact, that only those SMEs that are growing fast create additional jobs. Generally, job creation by the bulk of SMEs is most times offset by SME job destruction due to business failure. Furthermore, survivalist businesses in the informal sector do not create jobs. Therefore it is important to look to high growth SMEs for job creation (NESTA, 2009:3; UK Department for Business Innovation and Skills, 2009:10; Smorfitt, 2009:24; Moreno & Casillas, 2007:69; Naude & Krugel, 2002:1; Hallberg, 2000:5; Mead & Liedholm; 1998:16).

Research by NESTA in the United Kingdom (UK) and separately the UK Department for Business Innovation and Skills, showed that within the SME sector, of those enterprises employing more than 10 staff, only six (6) per cent of the enterprises were high growth enterprises. This percentage drops even further when compared to total SME numbers. These high growth enterprises created more than 50% of new jobs created over the three year period of the longitudinal study from 2005 to 2008. These enterprises tripled their staff numbers during this period. Those enterprises that declined in size were equal in number to those enterprises that only increased their size to a very limited extent (NESTA, 2009:4; UK Department for Business Innovation and Skills, 2009:10; Motohashi, 2001:6).

Furthermore, although the expectation is that new businesses would be high growth enterprises, of those that were high growth and generating jobs, those who were more than five (5) years old comprised 70% thereof. It is implied that in older enterprises the existing staff were retained. The research indicates that 62% of enterprises failed in the first 10 years, 3.8% of the original start-ups had more than 10 staff members, while only 1.9% had more than 20 staff members after 10 years (NESTA, 2009:4; UK Department for Business Innovation and Skills, 2009:11).

It can therefore safely be assumed that there are at least three different entrepreneurial types. These would be informal sector survivalist entrepreneurs, formal sector non-growing entrepreneurs and formal sector high growth entrepreneurs. This reinforces the findings that many different types of entrepreneurs exist.

2.4 Critical success factors

Critical success factors are those factors which empirical research has deemed to be of critical importance to the success of all enterprises. Unlike entrepreneurial characteristics, which cannot be used as determining factors in deciding whether someone is entrepreneurial or not, the critical success factors are a lot more likely to be determinants in the success of an enterprise.

These critical success factors are important in designing interventions. Cognisance must be taken of these critical success factors, for both start-up and growth phases of the enterprise lifecycle. The critical success factors are not listed in order of importance, but rather in order of the sequence in which they might occur in each phase of the lifecycle. They need to be addressed as part of the provision of business development services (BDS).

They are provided for background information, and to endorse once again the importance of finance in both phases of the lifecycle.

A literature review of the critical success factors for start-up and growth phases of SMEs yields ten (10) critical success factors for start-ups and twelve (12) criteria for growth phase SMEs. These results are summarized below in Table 1.1 and Table 1.2. In Table 1.1 item 9 specifically lists the need for capital and a capital source during the start-up phase.

Table 1.1 Summary of start-up critical success factors

Number	Phase	Description
1	Start-up	Opportunity awareness
2	Start-up	Market research
3	Start-up	Differentiating factors
4	Start-up	Business model
5	Start-up	Strategy
6	Start-up	Feasibility study
7	Start-up	Business plan
8	Start-up	Location
9	Start-up	Amount and source of seed capital
10	Start-up	Decision making ability

Source: Smorfitt, 2009:40

The differences between the critical success factors for start-ups and those for growing Firms, is noticeable. These differences will have an impact on the interventions planned and executed by governments for both growing and start-up SMEs. It is clear that they require different solutions. The only common factor to both is the entrepreneur.

The finance need is referred to in Item 5 in Table 1.2. The finance need is seen as being a skill which allows the entrepreneur to know how much capital is required, and where best to source it.

Table 1.2 Summary of growth critical success factors

Number	Phase	Description
1	Growth	Possess general management skills / experience
2	Growth	Possess strategic management skills
3	Growth	Possess technical skills
4	Growth	Possess organisational structure
5	Growth	Possess financial management skills
6	Growth	Possess leadership skills
7	Growth	Possess communication skills
8	Growth	Possess inventory management skills
9	Growth	Possess marketing skills
10	Growth	Possess contingency management skills
11	Growth	Controls and systems
12	Growth	Growth oriented

Source: Smorfitt, 2009:40

The need for capital in business start-up and growth is once again endorsed. This highlights the fact that the phase in the lifecycle the enterprise is located in is the fourth of the key issues for governments to take into account in designing their interventions, being predominantly required during start-up and growth.

2.5 Education

Education is considered by Porter to be an extended factor condition, over which the government does have control (Porter, 1998:186). Education includes primary and secondary education. It also includes artisan, technician and university graduate education.

Education is a critical component in innovation and growth. Well educated people are required as both staff and entrepreneurs (Ewing Marion Kauffman Foundation, 2007:2). Following this educational option was Japan. Japan focused part of it's efforts on increasing the number of start-ups by a factor of 2 or more as they were experiencing more failures per annum than start-ups (Japan, Online 15 April 2004:3). The Japanese government intended to achieve this by a range of educational projects, and by reducing the barriers to recovery from bankruptcy based upon research that indicated that entrepreneurs who had failed often made a recovery and success on a second attempt. (Japan, Online 15 April 2004:3).

A further supporter of educational interventions was New Zealand. New Zealand found that many efforts to stimulate the country's growth were still too slow and so focused on promoting an entrepreneurship culture, enabling access to skills and expertise, and enabling access to innovation and new technologies (New Zealand, Online 15 April 2004:8). They also attempted to educate individuals and Firms on how to access finance (New Zealand, Online 15 April 2004:6).

2.6 Land ownership

A key factor in banks providing a loan is to extract some form of security from the borrower as a risk mitigation tool. In poor countries this is extremely difficult as the intended borrower has no assets to provide as security and in rural communities this situation is further exacerbated.

An asset favored by banks as security, is land and buildings as immovable assets. Banks need borrower ownership of the land, in order to be able to enforce their rights in the event of default by the borrower.

However, in many developing countries the rural and the poor have tenure but not ownership, and gaining ownership is near to impossible. Land ownership is often vested in government or tribal systems of government, neither of which are useful to those with tenure without ownership. In Namibia, 50% of all land is communal land which according to law and the constitution is owned by the State.

An Internet search revealed that land at Afrodite Beach in Namibia is currently selling at N$750 per sq m as a minimum, and N$ 2500 per sq m as a maximum with services supplied (Nels Estates, Online 23 July 2010). Therefore assuming that Namibia is 834,295 square kilometers, and as a worst case scenario the land is worth only N$10 per square metre, the land in Namibia is worth a minimum of N$8,342,950,000,000, half of which is owned by the government. However, while the land remains in the hands of the state it has no real value as it cannot be traded on open markets and the citizens cannot use the asset to extract capital in the form of a loan.

The data provided by the Namibian government indicates that in urban areas 38% of land is informally occupied without legal title, and in rural areas 70% of land is

informally occupied without legal title. (Cadastral Template, Online 20 July 2010). Therefore, the government has effectively lost the economic use of the land to the occupants. The question is simply how ownership can legally be transferred on an equitable basis, as the future owners already have tenancy, and in so doing the capital can be unlocked and Namibia can see an enormous jump in growth with such a large capital injection into the economy (De Soto; 2001:95).
Therefore, Namibia is ideally positioned to support their entrepreneurs through land ownership, as the systems are all in place to allow for recognised formal land ownership tracking. The country has an organised and formal property registration system for tracking title deeds, albeit that in certain areas there may be a need for the surveying of land to define boundaries, specifically in the context of informal settlements.

2.7 Summary of design considerations

The above discourse should have highlighted the key issues to be considered when designing interventions, with capital being a very important criterion. The Theory of the Firm highlights the four components of production being capital, land, natural resources and entrepreneurship.

Entrepreneurship in turn links back to education, which is also linked by Porter's Diamond to skills development and education as an extended factor condition. This provides entrepreneurs with the high quality labour they need to use their entrepreneurial skills to drive growth, and thereby drive up employment. Therefore education is a critical component in the success of any government intervention for SMEs and entrepreneurs.

The different types of entrepreneur are also important in designing the intervention, as they have different needs, and different contributions to make.

The necessity for a formal land ownership tracking system, a deeds office, is also clearly necessary. This is in place within Namibia, which provides a great opportunity for Namibia going forward, as it creates an enormous opportunity to empower the poor and give entrepreneurship an enormous boost.

3. Recommendations

While it is a simple process to list many intervention options, a key factor in designing interventions is the cost to the government, as eventually the cost thereof has to be passed back to the taxpayer. Therefore, it is imperative that interventions be cost effective and offer a good return on investment.

Ongoing research is one of the most critical components of any government intervention. If interventions are not externally monitored and evaluated, there is no mechanism for evaluating the quality and relevancy of the outputs, nor the return on investment. However, the starting point of any quality research project is suitable and accurate data.

A common area of intervention failure is often a lack of data regarding SMEs of all persuasions. A simple, low cost, business friendly system of tracking businesses is extremely important in being able to affect quality and useful research. A simple licencing system is required for all businesses.

Although it is not the only issue, or arguably even the most important constraint, access to finance remains a major constraint and is an issue where government can assist in overcoming market imperfections.

3.1 Economic council

Appoint an economic council which is equally balanced in numbers between local and international members, and ensure a mix of academics, SME specialists, successful business owners from the SME sector and large business, and economists. Ensure the members are able to add real value, and are not political sycophants. Let the President and the Ministers of Finance and Trade lead the group forward.

The purpose of the group would be to develop economic strategies which would lead to cluster development within the Namibian economy. These selected clusters would then inform educational efforts at all levels, as well as innovation efforts within Namibian universities and businesses. High growth enterprises are highly dependent on high levels of innovation, and the best solution to encourage innovation is to create cluster-based centres of excellence.

There is a strong need for a global perspective, but just as strong a need for a local and regional perspective, within the council, as many opportunities rest within the regional borders. The council membership must reflect these opportunities. However, the council members must also be perceived to be advanced and futuristic thinkers based upon sound theoretical bases, and not traditionalists who resist change. The economists and the politicians will provide the counterbalance to this group, leaving a well balanced council. Furthermore, an international mix of members will ensure that objectivity is maintained at all times, as too often locally driven projects become highly subjective.

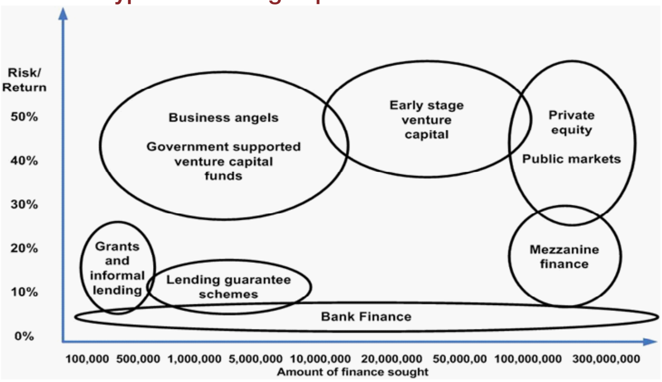
3.2 Capital formation

We have established that capital is a very necessary requirement for SMEs, both in the start-up and the growth phase. Of the three categories of entrepreneur, it is important to decide whether interventions are required for all three, and if interventions will be designed for each. Therefore recommendations will be made on the basis of the three categories of entrepreneur, as well as for the broader community.

In Figure 1.4, an overview of the types of finance available in the UK is provided. This shows the different positioning for each type of finance in relation to the amount to be borrowed and the expected returns in relation to the amount.
Bank finance is available across the full spectrum of loan requirements. However, it indicates how bank finance is based on a relatively low IRR of less than 10%. This is a lot less than the returns earned by angel funders and venture capitalists. Therefore, it follows that banks will be more risk averse than business angels, venture capitalists and private equity providers, who are all holding equity and will share in any future sale of the enterprise, and in interim profits. Therefore, government must beware of forcing banks to provide finance to SMEs, as it could compromise their financial position. It also highlights the fact that certain of these finance sources are not available in Namibia and this must be addressed as part of the efforts to form capital within Namibia.

It is also a reflection of the fact that these equity based lenders will be dealing with smaller numbers of SMEs than banks, and because of the higher IRR achieved, they can afford the time to do a more detailed due diligence assessment.

Figure 1.4 SME finance types indicating expected return in relation to amount needed



Source: UK Department for Business Innovation and Skills, 2009:8

Capital formation is an important component of the SME development process. Malaysia, on behalf of Asia-Pacific Economic Cooperation (APEC), did research with APEC members Brunei Darussalam, Canada, Chinese Taipei, Indonesia, Japan, Republic of Korea and United States of America into the sources of finance for SMEs in their countries. The results are shown below in Table 1.3 (Malaysia, Online 15 April 2004:2).

Table 1.3 Common sources of financing for SMEs among APEC members

Source	Percentage (%)
Commercial banks	59.8
Government	4.7
Self-financing	11.2
Equity financing	11.1
Family and friends	5.6
Venture Capital	1.4
Grants	0.4
Others (Trade Credit & Leasing)	5.8

Source: (Malaysia, Online 15 April 2004:2)

An important component of these data is that the APEC members who provided the data are comprised of both developed and developing countries and despite the perceived lack of funding by banks for SMEs, the majority of funding provided to SMEs is by banks. This must raise the obvious question as to whether banks are really a problem in the provision of SME loans, or whether it is a perception caused by the fact that government interventions are creating more enterprises, and this increase in numbers is resulting in an increase in demand that exceeds available capital allocated to this market segment within banks, which if filled would upset the banks' portfolios and ratios between the different levels of debt they carry, and possibly also contravene banking laws.

A key issue for banks is security, and the best way to provide citizens with security is to give them land ownership. The government owns the bulk of the land and can distribute the land as it likes. The question is how to do this on an equitable basis. The one country that springs to mind in this regard, as having resolved the land issue within a very short space of time after independence from Britain, is Singapore (Yew, 2000:116). The sooner land ownership can be transferred from government to the citizens, the sooner capital can be extracted from these assets, and used to boost entrepreneurial activity in Namibia (De Soto; 2001:95).

Remember that today many people have access to global information through access to satellite television and Internet. This has changed the aspirations of the younger generations. They no longer aspire to a large herd of cattle as a subsistence farmer in a rural area, but rather to branded clothes, fast cars, smart cellular phones and laptops. I spend a lot of time with students from all over Africa and I can assure you that their aspirations include a large house or two, satellite television, a wife and three children at private schools, international holidays, a Mercedes and a BMW, and KFC on demand. Government has to accept this urbanisation trend is occurring, growing, and will not stop. The sooner it is accepted, the sooner governments can turn this to their advantage (De Soto; 2001:95).

On the basis that there are approximately 2,100,000 citizens, 54% are of an economically active age, and each of these persons gets 1000 sq m, only 0.28% of the total government-owned land would be needed to be transferred. It would generate, at N$10 per sq m, N$11,340,000,000 of capital for the citizens of the country.

The government will earn rates on the land over the long term, the banks will give loans against the land as security, and the whole population has an asset they can borrow against and trade with. Furthermore, you resolve political issues around land ownership which has plagued many countries. Political empowerment is nothing without economic empowerment, and the easiest, cheapest means to achieving economic empowerment is by transferring the idle land that the government currently owns in an equitable manner. This is a difficult task but not insurmountable as proven by Singapore (Yew, 2000:116).

Business angels and venture capitalists are important participants in the capital markets, as can be seen from Figure 1.4 above. Business angels and venture capitalists are difficult to find in developing countries for a number of reasons, not least of which is that there are very few wealthy individuals who are prepared to invest, and very few SMEs are investment options due to the poor quality of the SMEs themselves, simply as a consequence of where the country is in the development lifecycle (Thailand 2, Online 15 April 2004:7; USA, Online 15 April 2004:2).

The starting point is to provide angel funders and venture capitalists with tax incentives to invest in these businesses. The tax incentives can be used to focus investment on SMEs within specific targeted sectors which government wants to grow as part of a cluster strategy defined by the economic council. Find individuals or organisations, highly respected within the business community, to launch these capital provision organisations. Developing an angel funders body requires the input, on numerous levels, from wealthy individuals seeking to make profit, and simultaneously benefit from government incentives. The Namibian tax office could easily select the top individuals from their records and invite them to a function. The function would highlight intended government tax incentives for angel funders, explain the benefits of a formal angel funders network, ask the attendees to consider the establishment of a formal angel funders network and then facilitate the group to establish itself formally and elect office bearers.

Attempt to attract support from the South African Venture Capital Association. The country is close enough geographically, and has a strong relationship with Namibia, and they may well be interested in working with Namibia to develop a local association, and would possibly also encourage members to invest in Namibia. Venture capitalists differ from angel funders, firstly in the amount they wish to invest, and also in that they are often formal enterprises in their own right, as opposed to angel funders who are often wealthy individuals investing in other enterprises. Tax incentives must be extended to local and international investors and possibly even the man on the street with a government backed bond. However, venture capitalists like to be near centres of innovation, as this is the secret to their high IRRs (NEPRU 2006:2). This once again highlights the need for innovation based cluster development.

There is an undoubted need for capital at three separate levels within the SME sector. The first is the survivalist SMEs in the informal sector. The second is the formal sector SME who is starting up, and most importantly, the formal sector high growth SMEs.

3.3 Survivalist

The first sector is a government imperative and a funding agency needs to be set up to process this funding requirement. It falls outside all existing funding options shown in Figure 1.4. However, this must not be run by bankers, but rather SME development specialists managing a well structured plan for informal sector SMEs. This must be seen as development capital, not investment capital and must be issued under development rules of engagement.

The informal sector must essentially be formalised in order to allow government to assist its participants, by protecting against things like overtrading. Each funded application must be tracked and must be excluded for a lengthy period thereafter from applying for further funding. Furthermore, attempt to inculcate a formal approach to business.

The survivalist cannot be ignored, as they play a vital role in poverty reduction. However, they cannot simply be left to their own devices. The strategy must assist those survivalists who can, to move through to the formal sector, thereby creating more opportunities for new survivalists to be created in their place. This requires therefore that government needs to provide a formal trading area for these survivalists. These must be in locations where they currently trade in illegal situations, but in formal premises. They must be licenced, albeit that the licence fee is negligible, and given some basic training on costing and markup and margin. On registering they must be provided with their start-up capital, provided by government. Building formal premises will in itself provide further construction opportunities for SMEs in this sector.

Thereafter they must be obliged to attend ongoing training which will improve their chances of success and growth into the formal sector. Their progress must be tracked on a longitudinal basis so that the intervention can be fine tuned to meet their need for success.
Rules must exist for how many times you can apply, and the minimum time between applications. This will stop attempts to defraud the government as it would be an unsustainable fraud for the fraudster.

3.4 Life style entrepreneur

This group is best suited to bank funding. They are generally fond of purchasing life style assets, from which their name is derived. These would include second holiday homes, caravans, boats, motorcycles, and a variety of motor vehicles.They generally have assets that can be provided as security for the bank loan, therefore making it easy for the bank to assess the risk and provide the loan.

Many banks in Africa have moved away from relationship banking, towards centralised credit committees. Research indicates that banks that do not use relationship banking are less likely to make loans to SMEs. Therefore, Namibia should review the existing banks to gain an understanding of whether they are using relationship banking methodologies or credit committees. If they have all moved to credit committees, then perhaps it is time to look at establishing community banks. These are banks owned by local business people, possibly the same people who would be angel funders. These banks are not allowed to act on a national basis, and have slightly less stringent rules than national banks. In the USA, SMEs have much simpler and easier access to funding, as they are in most cases dealing with community banks. In Australia the major banks pulled out of smaller towns and cities and their place was filled by community banks. This saw SMEs finding funding that much more easy to access, to the extent that national banks were forced back into these markets due to investment losses which upset their ratios of available capital, but were unable to restore business to previous levels.

However, these banks are successful because they are locally owned and managed. They understand national and local markets, and local entrepreneurs are generally known by them. They are completely relationship based and it reflects in their profits and their loans to SMEs. Community banks, in the USA style, have proven that they add enormous value to making local economies work. They know and understand local markets and are best suited to making the best decisions regarding start-up and growth enterprises. If a well known and respected local business personality owned the local community bank, a loan from the bank, would be an endorsement of the need, and would also provide a further boost to the start-up owner. Existing banks may well attempt to compete, but that will be to the benefit of the SMEs and the economy at large.

A tax incentive must be provided for businesses that retain their profits, and do not distribute to the shareholders whether by dividend or bonus or salary. This will increase the amount of working capital each business has to work with, and will stimulate growth. This self-funded growth is ideally suited to the low growth life style entrepreneur, but will obviously be of benefit to all entrepreneurs.

Project funding as offered by the Development Bank of Namibia is ideally suited to certain industries. However, care must be taken to ensure that borrowers cannot use this continually, and that the borrowers must become financially independent, which comes back to building a working capital buffer within the business. The profit retention tax incentives discussed earlier should help to reduce the dependency on this government source of project funding.

Tenders can also be structured to create more specialised businesses. For example structure deals to force use of particular equipment hiring businesses that will be created for this purpose, if they do not already exist. There must be sufficient numbers to engender competition, but not so many that it is impossible to make sustainable profits. These guaranteed clients will allow banks to fund these new businesses in the acquisition of assets. These will be businesses that can also provide services to private sector clients. This would require a complete value chain and supply chain analysis of the selected industries, such as the construction sector, before commencing with the process.

Continue expanding the Common Facility Centres throughout Namibia as quickly as possible. Make sure these centres are able to offer the best service in respect of knowledge, intellectual property and Internet speed. This is possibly closely related to e-government activities, which make information available to citizens quickly and efficiently. As a starting point, publish all import data so that local businesses can look to local manufacturing opportunities once they have an understanding of the volumes being imported and the value thereof. Imports will always be a reality in a small population country, but opportunities do exist for import replacement manufacturing. Try to focus the knowledge and intellectual property available in these centres around the targeted clusters for Namibia.

3.5 High growth entrepreneur

The third sector requires more complex solutions, but the key focus of government interventions should be on this section of the SME community, as other countries such as Japan have done (Motohashi, 2001:2). The UK have now also found this to be the best area to focus on (NESTA, 2009:3; UK Department for Business Innovation and Skills, 2009:10; USA, Online 15 April 2004:2). There is now mounting evidence that the few high growth enterprises in every country are those that are creating GDP and employment growth. Therefore, the focus of investment and effort must be on this narrow niche within the SME sector.

The development of angel funding and venture capital associations is crucial to the development of a healthy population of high growth SMEs (Thailand 2, Online 15 April 2004:7). These funders are required to help fund the high growth SMEs, as these SMEs are often considered by banks to be overtrading and therefore high risks.

Various theoretical and empirical arguments support the existence of a relationship between the availability of financial resources and the growth rate of the Firm. Research on growth in small and medium-sized Firms shows that access to finance for SMEs will determine their growth rate. The conclusion that can then be drawn is that access to sufficient capital will allow for greater growth. Both desktop and empirical research also indicates this conclusion to be correct. Growth requires substantial financial resources, so rapid-growth Firms are typically cash starved (Moreno & Casillas, 2007:74).

Government also needs to drive innovation for these high growth SMEs. (Ewing Marion Kauffman Foundation, 2007:3; Thailand 2, Online 15 April 2004:7 Motohashi, 2001:2) Link University funding to innovation and businesses created around the new innovative research, as well as businesses who have partnered with universities in extracting commercial value form academic research, and ensure that entrepreneurship and innovation are included as a core component of every course offered at any tertiary educational institution. Furthermore, ensure that business has access to university staff and research in order to facilitate greater innovation (Yamada, 2004:303). Ensure business development service providers offer regular training on various aspects of innovation to the business community, by providing tax incentives for these courses. This could also be linked to innovation incubators, on condition that the beneficiaries are high growth enterprises.

Pay the international patent registration fees for high quality new intellectual property (IP) created. This is often outside the financial capacity of SMEs. Let the economic council evaluate the IP in the context of whether it should be protected by international patents.

There is also a need for data sharing between lenders. Risk for lenders is mitigated by knowing more about the borrower. Knowing the full exposure currently held by the borrower with all lenders will help lenders to assess the risk in lending more to a particular borrower. Ensure that competent credit bureaus exist for SMEs. The more information available on the business, the less banks have to rely on personal securities and track records (Jappelli & Pagano, 2000:30)

4. Conclusion

It is important that interventions are well planned and thought out. Too often interventions are rushed out in a desire to solve the problem quickly. Furthermore, there may well be work required to prepare the way, in order to allow for the monitoring and evaluation of the project.

The interventions must be examined in the context of other legislation to check for possible conflicts, as these simply lead to cost over-runs and project delays.

It is imperative that a highly innovative and focused economic development strategy is developed. This will provide the core of the future SME developments, particularly in the high growth SME sector which is dependent on innovation to create the economic and job growth.

High growth SMEs must become the focus point of future large scale efforts. High growth SMEs do not grow in isolation. They require other bigger players and possibly even global competitors to ensure the innovation component of the project.

These recommendations are achievable for Namibia, and may well have even started in one way or another, both within the scope of government or not. The recommendations can be tabulated as follows for ease of reading in Table 1.4 below:

Table 1.4 Summary of intervention recommendations

Beneficiaries	Functional or Selective	Description
All businesses	Functional	Establish economic council
High growth SMEs	Selective	Establish Angel Funders Association
High growth SMEs	Selective	Establish Venture Capital Association
High growth SMEs, high net worth individuals and venture capital companies	Selective	Tax incentives for investors in SMEs
Low to no growth SMEs	Selective	Tax incentives for retaining profits in SMEs
Survivalist entrepreneurs	Selective	Survivalist funding and strategy
Survivalist entrepreneurs	Selective	Survivalist trading premises
All citizens without property ownership	Selective	Transfer ownership to landless citizens
All citizens, survivalists, low to no growth SMEs and perhaps high growth SMES	Selective	Community banks
Low to no growth and perhaps high growth SMES	Selective	Targeted tenders
All individuals and SMEs who have valuable intellectual property	Selective	Payment of patent registrations
SMEs and banks	Selective	Credit bureaus
All	Functional	Focus education across all tiers on entrepreneurship and specific needs within clusters in Namibia. Develop centres of excellence that attract students from other countries.
All citizens, survivalists and SMES	Selective	Common Facility Centres
All	Functional	Simple business licencing implemented

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A Discussion of the paper on 'SME financing: strategies for Namibia

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Discussant: David Nuyoma, DBN Chief Executive Officer

1. Introduction

It is a pleasure to participate in the BON Symposium 2010 as discussant on Dr Rob Smorfitt's paper: 'SME Financing: Strategies for Namibia'. I would like to, at the outset, recognise and thank Dr Michael Humavindu, Head of Research at DBN, for the background research in preparation of these remarks.

Dr Smorfitt's paper sets out to provide some solutions to the perennial problem of access to finance for SMEs in Namibia. As such, the paper focuses on four key questions, namely:

- What are the major impediments affecting SMEs' access to finance and how can those be addressed?
- What is the role of stakeholders like SMEs themselves, government, banks, etc.; in promoting SMEs' access to finance?
- What alternative forms of finance are available to SMEs; and, finally
- How did other countries promote SMEs' access to finance and what strategies were implemented to ensure success?

I shall discuss the paper in terms of whether it did, in fact, treat these questions and will also provide an alternative view on the matter; with the discussion structured as follows:

- The section hereafter provides a brief review of Dr Smorfitt's paper; followed by the views of the Development Bank of Namibia on SME financing strategies; which, in turn, is followed by my concluding remarks.

2. Dr Smorfitt paper: review

The paper starts off with the rationale grounded in economic theory, looking at why an SME financing gap exists in general. As such, it considers the issue of why government intervenes in the market system; which is commonly as a result of both market and government failures.

Market failures in the context of SME financing relates, among others, to commercial banks not having the requisite skills set to assess SMEs' risk profiles, whereas government failure could be manifested through the setting of interest rate ceiling regulations that could adversely affect banks' lending to SMEs.

The paper also differentiates between ‘functional’ and ‘selective’ interventions, stating that interventions for SME financing be classified under the latter.

Section 2 of the paper points to a number of issues to consider when designing SME interventions. Using the ‘Behavioural Theory of the Firm’, the paper argues that government SME interventions should focus on the four factors of production: capital, land, natural resources and entrepreneurship.

The paper argues that government control over natural resources is limited due to a country’s endowments, and that its ability to facilitate access and supply of finance is also limited. Government can, however, facilitate access to finance by making land available and also by helping build an entrepreneurial culture through appropriate training and skills development.

The paper suggests that commercial banks place heavy emphasis on collateralised lending, with land and buildings being the primary assets. Lack of property rights over land, especially in communal and informal urban areas, however, hinders the utilisation of land for collateral purposes, and thus hinders entrepreneurs’ access to finance.
The fact that Namibia has a formal land ownership tracking system through a deeds office, presents an opportunity to advance the poor and entrepreneurs’ access to resources.

Section 3 of the paper provides recommendations on SME financing for Namibia. In the first instance, the paper advances the notion that government interventions should be based on the principle of cost-effectiveness and should offer adequate rates of return. Secondly, monitoring and evaluation through on-going research is presented as a key component of government interventions. Finally, the paper states that accurate data on businesses and SMEs is vital for the design of appropriate government interventions.

The paper further presents direct interventions strategies, which include the following:
- **Establishment of an Economic Council:** It suggests that an economic council comprising of SME practitioners and other professionals be established to devise appropriate economic strategies and cluster-based development. Such cluster-based development should feed into educational and innovation programmes within the country’s universities and businesses.
- **Capital formation:** The paper states that the three categories of entrepreneurs: survivalist, start up, and growth phase entrepreneurs, require different capital formation interventions. Such interventions could include grants, guarantees and bank finance.

The returns from bank finance seem low compared to that of business angels and venture capital. One would thus expect banks to be more risk averse when it comes to SME banking. Using the example of the Asia-Pacific Economic Cooperation (APEC), where research shows that banks provid0e roughly 60 per cent of SME financing, the paper considers the basis for these banks' approach. Looking at Singapore, one of the aspects highlighted is the presence of secured property rights, with land used as security.

Following from this, the paper underscores its advocacy for ensuring land tenure rights. The paper also makes a case for business angels and venture capital, and advocates for government intervention through tax incentives.

It puts forward that the Economic Council could identify the sectors to be developed, and that an Angel Funder's Body could be developed thereafter. The Angel Funder's Body would be provided with tax incentives to finance the targeted sectors. A Venture Capital Association could also be formed, through partnering with established South African associations, and also benefit from tax incentives and innovation-based cluster development.

- **Survivalist entrepreneurs:** The paper advocates for development capital through a government agency; offering development finance, training, monitoring and graduating elements, for this segment.
- **Lifestyle entrepreneurs:** This group could be best served through bank funding, as it commonly has the requisite collateral.

The paper also advocates for Namibia investigating the possibility of community banks, as they have less stringent rules and are more attuned to local entrepreneurs' needs.

To help businesses grow and reduce their dependency on project funding from entities like the Development Bank, a tax incentive for businesses to retain their profits, is suggested. This will help increase businesses' internal resources and will reduce external resource dependency ratios as a result.

The utilisation of tenders to create specialised businesses, is also promoted by the paper. It further argues for a need to develop Common Facility Centres throughout the country to provide services such as knowledge and intellectual property support as well as internet access. Such access could help spur opportunities in import-substitution manufacturing, for example.

- **High growth entrepreneur:** High growth entrepreneurs require a range of, and more complex, interventions. Government intervention could, for example, be directed to those SMEs whose growth enhances GDP growth and employment creation.

Government could also provide a link between this type of SME and universities, to promote innovation linkages between academia and business. Tax incentives could also help businesses access innovation training through business development service providers.

Further, the Economic Council could help settle the cost of international patent registration for identified high growth SMEs.

The paper, finally, states that data sharing between lenders would help decrease information asymmetry in lending and reduce the need for stringent collateral requirements because of a lack of information on SMEs.

In summary, the paper considers the reasons for SMEs having problems accessing finance and presents some thoughts on possible remedies. The main themes revolve around interventions:

- being designed on the basis of the different type of SME entrepreneur, suggesting that cluster based development is best; and
- that government interventions should ensure, through monitoring and evaluation, that interventions are cost effective and that they provide a reasonable rate of return.

In terms of capital provision, bank finance is still considered important, but it is noted that facilities like angel funding and venture capital should be promoted through the introduction of tax incentives, among others.

As an immediate strategy, providing legal tenure to communities in communal and informal urban areas, would increase SMEs' ability to offer collateral and so increase their chances of obtaining bank funding. The paper also calls for different forms of finance being available for SME lending.

The paper, however, does not address the role SMEs need to play themselves in improving their chances of obtaining funding. It would, further, have gained by presenting concrete realities of the SME finance environment in Namibia.

The DBN contribution draws on the recommendations of the Smorfitt paper and considers some of the areas that are not addressed in detail in the paper.

3. DBN's views and approach

3.1 Local context

Namibian SMEs contribute close to 12 per cent to GDP and employ 20 per cent of the total workforce (Nepru, 2003). The existence of a financing gap in the economy is confirmed through research by the Parliamentary Standing Committee on Economics, Natural Resources and Public Administration (2009); the World Bank (2007), Knutsen (2003) as well as the Namibia Chamber of Commerce and Industry (2010).

More than 40 per cent of Micro, Small and Medium Enterprises (MSMEs) in the country identify access to finance as the most serious obstacle to growth. Access to, and the cost of credit, both feature prominently as challenges faced by the sector. Stringent collateral requirements are more of a challenge among medium to large enterprises; followed by cost of credit.

The twin challenges of the cost of borrowing and access to finance have to be considered when devising SME financing strategies. Generally, in Africa, there are supply side, demand side and institutional constraints to financing SMEs (Proparco, 2009). These involve the following:

3.1.1 Demand-side constraints

Demand side constraints arise from SMEs' internal weaknesses. The principal constraint relates to the limited information provided to funders and on which basis credit decisions are made.

SMEs also tend to be inadequately structured, especially in terms of equity, and thus have uneven financing structures. SMEs' limited organisation in terms of human resource, accounting and other control functions is a further key limitation. SME owners' personal finances and assets are, as an example, frequently bundled with their companies' total assets.

3.1.2 Supply-side constraints

Supply side constraints relate to common factors inhibiting banks' willingness to lend to SMEs. These include capital constraints, banks' capacity constraints, the level of risk and transactions costs related serving SMEs. In some instances, it also includes a systematic bias to larger firms or holding high-yielding debt.

3.1.3 Lending infrastructure, policy and institutional constraints

A further constraint relates to the lending infrastructure that prevails in the country. Lending infrastructure involve market failures prevalent in an economy that could inhibit SME lending. The absence of creditor's rights that protect lenders from non-payment, for example, could decrease small business lending levels.

Weak collateral regimes also inhibit SME lending as assets that could be used as security for loans, are not classified as such. The presence of proper credit registries could facilitate the use of credit scoring technologies, which will reduce small business lending costs immensely. Research shows that the presence of a Credit Bureau reduces the cost of small business lending by up to 25 per cent.

3.2 Approach to SME Financing: Experience from other countries

Research by the ADB (2006), the World Bank (2008) and Propaco (2010), provides recent literature on how countries in Asia, Latin America and Africa can approach the issue of access to finance for SMEs.

Various countries have instituted directed lending programmes or policy-based lending to assist SMEs with financing. India, for example, has a Priority Sector Lending programme which directs public and private banks to earmark 40 per cent of their net credit to sectors like the SME sector.

The Philippines, in addition, has a mandatory requirement for banks to set aside eight per cent, and at least two per cent, for small and medium loans of their total portfolios. Other countries, like Pakistan and Thailand, have established dedicated SME banks.

These are all efforts driven towards reducing supply side constrains for SME lending; and involve the formation of special development funds or banks for SMEs, and also cooperation with commercial banks through directed sector lending policies. Governments can also work with commercial banks in an effort to correct capacity constraints in order to better service the SME market.
In order to improve demand side constraints, countries like Thailand have established Capacity Building Funds to improve SMEs' internal competitive structure. In this regard, the role of government is important to ensure appropriate training interventions. Subsidised training and mechanisms for banks to experiment with new approaches towards SME lending, are a further solutions presented.

The role of government becomes even more pronounced when it comes to the issue of strengthening the institutional foundations of lending. Strengthening creditors' rights through, among others, establishing quasi-legal institutions for processing legal suits brought by banks against defaulting borrowers, helps improve repayment behaviour and enhance banks' willingness to finance SMEs.

Similarly, improving the Collateral Classification System incentivises banks to introduce products like leasing, invoice discounting, and factoring, which attempt to circumvent the problems of collateralised lending.

Research also shows that introducing SME Credit Bureaus significantly reduces the cost of lending to SMEs and improves access to finance. Moreover, research shows that governments have continued to use credit guarantee schemes to increase SME lending. Rigorous evaluation of such schemes still has to be undertaken though.

4. DBN's experience in lending to SMEs: 2005 to 2009

DBN's lending to the MSME sector is guided by its MSME Credit Delivery Strategy (2008). The strategy is a living document and reworked on the basis of changing circumstances. The DBN presented the following offering to the sector in the first five years of its existence:

- Bridging finance: tender-based finance;
- Term loans through financial intermediaries (by extending Lines of Credit);
- A microfinance apex facility; and
- Innovation Fund: concessional loans for innovative ideas;
- Mentoring programmes offered through financial intermediaries and dedicated service providers like SMEs Compete and IMLT.

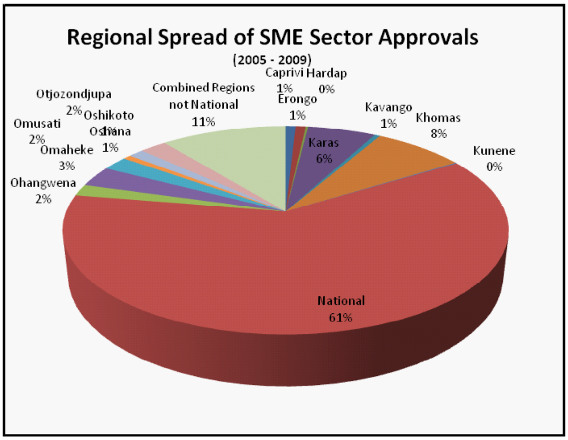
This approach is derived from the Bank's intent to:

- provide finance for enterprises that create jobs;
- provide funds to commercial lenders, for on-lending to enterprises, to reduce the cost of loans that work towards the development of the country;
- Strengthen SMEs' own capacity; and
- promote innovative ideas at the micro & small entrepreneur level.

The DBN approved funding valued at N$ 267.1 million towards the MSME sector during 2005 to 2009 period (DBN, 2010).

Analysis of the portfolio shows that approvals with nation-wide outreach account for two-thirds of the total; illustrating increased access to finance. The term loans offered through financial intermediaries made a particular contribution in this regard, and is as a result of specific targets for reach, having being set.

Figure 1: Regional spread of SME sector approvals (2005-2009)



On the basis of the experience of the past five years, DBN's future credit delivery strategy will involve:

- Gradual expansion of direct provision of finance by the DBN;
- Reduced reliance on commercial bank infrastructure, and pursuit of smart partnership models with other financial intermediaries like Nampost to ensure reach;
- Greater emphasis on the introduction of appropriate products for the MSME market through external and internal research;
- Introduction of new products, and continued review of existing products.

5. Suggested approach on SME financing in Namibia

Given the realities of presented above as well as other countries' general experience in SME financing, the Development Bank proposes consideration of the following on SME financing in Namibia:

5.1 Government policy on SME financing (policy-based lending)

It is imperative for government to prepare a policy-based lending strategy to direct SME finance through institutions like the Development Bank of Namibia. The DBN's Special Development Fund is one of the vehicles appropriate for such an approach.

This strategy should also deal with issues of interest rates; support to priority sector SMEs; and cultivation of backward and forward linkages between priority sector SMEs and public procurement. Knutsen (2003) in a study on impediments to black entrepreneurship in northern Namibia, comments on the very short value chain linkages that exists between SMEs and larger entities.

5.2 Strengthening of institutional capabilities and market information

The government and the central bank should encourage - and help in – designing the development of an SME lending database by both private and public banks. Such data will be useful for the establishment of a national credit bureau, but could be used for information sharing in the meantime.

The central bank could ensure that the database also includes an overall macro analysis pertaining to banking or lending statistics on SMEs in terms of sector or industry; financial products; non-performing ratios and financial statements to ensure the effectiveness of SME policy designs and interventions. It would also be useful if the central bank could design a minimum acceptable standard for accounting reporting on the SME sector.

5.3 Improving demand-side conditions

Demand side remedy programmes like training and capacity building, should be strengthened. Where feasible, the issue of land tenure could also be investigated by the government. Institutions such like Development Bank should continue to foster relationships with non-financial support service providers like the Polytechnic of Namibia, UNAM, SMEs Compete, IMLT and other relevant parties.

It is also important that initiatives like the Namibia Business Innovation Centre of the Polytechnic of Namibia that seek to encourage innovation in enterprise development, are supported. It is through innovation that SMEs can make a difference in terms of value add and provision of goods and services to society.

5.4 Improving supply-side conditions

Supply- side interventions could include the proposed SME Fund through the DBN referred to above.

Private banks could use their SME databases to foster closer ties with the sector and learn how to use the information in the development and design of SME lending. These banks could also investigate aspects of promoting new lending technologies, credit assessment skills, the diversification potential of SME lending (where loans can be bundled with other products) in order to enhance their margins from SME lending.

Capacity building programmes for commercial banks should be fostered and utilised to accommodate SME lending. The Development Bank, in partnership with the central bank could continue to research appropriate products to serve the sector.

The SME financing offering in Namibia is shallow and needs to be deepened. There are opportunities to plug the gaps in the form of financing for micro entrepreneurs in general and women in particular. This may require a special funding mechanism from government to provide seed capital towards micro-finance service providers. The micro enterprise sector is an important source for formal SMEs.

There is, furthermore, an opportunity for specialised financing to cater for the unique needs of different entrepreneurs through venture capital facilities, among others.

In light of this, it is pleasing to see the emergence of innovative initiatives, like those adopted by Kongalend and the Microfinance Bank, Fides.

5.5 Improving lending infrastructure

Improving the lending infrastructure could start with efforts to improve the information environment. The establishment of an SME Credit Bureau is important to improve the lending information environment related to SMEs.

The Development Bank and Bank of Namibia could be the leading entities in this respect. Government, through its Ministry of Justice, could, on the other hand, look at improving the current collateral classification regime as well as the strength and efficiency of the creditor rights system.

Some lending techniques, like leasing, could also be adversely affected by the prevailing tax regime. There is therefore a need for continuous engagement with government to find solutions on some of these regulatory and legislative constraints.

5.6 Integration with national SME development programmes

Finally, it is important that these interventions are integrated with other national SME development programmes, such as the innovation, technological and business development services on offer. Integration is key to ensuring effective implementation of the overall national SME development strategy.

It is also imperative that networking initiatives for SME support stakeholders like the JCC be strengthened, for purposes of sharing good business practice, coordinating efforts, creating synergies, and acting as advocacy platforms.

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Conclusion and discussion on key issues emanating from the 2010 Annual Symposium

by
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The 12th Bank of Namibia Annual Symposium focussed on the theme "SME Development in Namibia". All the speakers agreed that SMEs play a pivotal role in the country's economy and therefore need to be promoted in order to contribute even more to employment creation and poverty reduction. The lack of access to finance by SMEs was singled out as the most important impediment to the growth and development of SMEs in Namibia. As a result the speakers and participants agreed that there is need for a radical change in the way financial institutions grant financing to SMEs. The financial institutions were urged to adopt a more flexible approach when dealing with SME financing, taking into account the unique circumstance of the SMEs.

Apart from access to finance, the SME sector also faces other challenges such as lack of entrepreneurial skills. The aforementioned challenge is also critical in that it leads to the demise of some SMEs due to mismanagement of SME companies. In order to overcome this challenge it was proposed that skills development and mentoring services should form part of a good SME development strategy or programme. Existing specialised institutions offering such services to SMEs should be strengthened in order to reach more SMEs and should also receive more financial support to enable them to roll-out their services to areas where they are currently not being offered.

In order to ensure that SME development takes place and succeeds, it was suggested that an economic council be set up, reporting directly to the President. This would guarantee political buy-in and support. The proposed council should consist of eminent persons (including business people and academics) both local and international. The core function of the council will be to give direction and guidance on SME development through designing and implementing appropriate policies and guidelines. At present, the Ministry of Trade and Industry is responsible for SME development and therefore there might be a need to look at the proposed idea of the council, which might complement and/or replace the functions currently handled by the Ministry in order to streamline SME development in Namibia.

The Symposium provided a platform for an exchange of views on the important topic of SME Development in Namibia, which should lead to a better approach on developing SMEs in the country for the benefit of entrepreneurs, employees, government and the economy at large. Below are some of the key issues that emanated from the open discussions during the Symposium.

I. Data limitation

It was noted at the Symposium that data limitations on SME sector is a key concern in terms of analysis, evaluation and monitoring. The latest data used by presenters were from a survey done in 2004/5. Presenters indicated that the data needs to be updated to ensure the latest reflection of the current status of SME development in Namibia. In this regard it was noted that the Ministry of Trade and Industry conducted a business and enterprise census/survey and which, once data are released, would give an updated indication on the sector.

A related issue mentioned at the Symposium was that in order to overcome the lack of knowledge about the contribution of SMEs to the economy, and for the authorities to target the sector better through policy, Government needs to incentivise SMEs to register and become formal businesses. The significance of the problem of not knowing the exact current status of the sector is such that if it cannot be measured, it cannot be mended as well.

II. Financing

The Symposium noted that access and affordability of finance by SMEs remained one of the key challenges to the development of SMEs in Namibia. It was further noted that commercial banks have appeared to represent the interest of the SMEs, where as by their very nature, are not tailored to meet the specific needs of the SMEs. Commercial banks are accused of getting development funds in order to finance SMEs, but retain their stringent lending criteria and high financial charges. Such conditions call for the re-thinking of the banking system to ensure that banks make money from financial intermediation rather than from fees and charges.

Access to finance as a constraint was contrasted by the argument that entrepreneurs need to acquire necessary skills and penetrate local markets (for sub-sectors where this is possible) and that would increase their chances of accessing finance at affordable terms. Nonetheless, the Bank of Namibia was requested to craft a banking model for commercial banks which is supportive and SME friendly.

With regards to access to finance, Namibia was urged to explore ways and methods of overcoming financial access constraints that have proven successful elsewhere. Examples in this regard include the registration of movable collateral the way it is done in China, successful financial support for SMEs in India and Bangladesh, Government supported Business Angel Networks and establishment of private sector credit bureaus in various countries.

Most of Namibia's SMEs are involved in trade-related activities rather than in value addition and this makes the involvement of institutions such as UNIDO difficult because UNIDO's mandate is to fund value addition or manufacturing activities. There is hence, an opportunity for SMEs to venture in manufacturing and attract funding from international institutions.

III. Domestic SME protection policies

Besides access to finance, other challenges facing the SME sector include the supply constraints, fierce competition from Chinese traders and South African retail chains, demand-side constraints whereby locals are said to prefer buying foreign supplied goods and services, lack of appropriate institutions and legal instruments to protect patents, and lack of transparency in procurement, amongst others.

It was noted that the lack of local SMEs protection from unfair foreign competition compromises the growth and development of the sector. An example of such protection could be in the form of appropriate regulation which will make it difficult for bigger businesses to enter the market and crowd out SMEs. An example was given of Angola, where businesses to a certain size require a ministerial council's approval.

SMEs also expressed concerns particularly on Chinese and RSA business that constantly threatens local SMEs. In this regards, there were calls to Government that there was also a need to protect local firms from such unfair practices through policy and legislation. However, it was pointed out that protectionism is not an answer in the long-term as it may work only for the short-term and not help the sector to develop and become competitive in the long-term.

At the same time, the Symposium noted that government is not doing enough to enable SMEs to access domestic markets. It was thus concluded that SMEs will not access external markets if they cannot even access their own market. Therefore, there is a call for Namibians to support SMEs by buying their products as well as to ensure that the sector improve on the quality and relevance of its products.

It was further noted at the Symposium that Namibia has adopted numerous policies towards SME development, but has done very little in terms of implementation. Government was called upon to begin matching their talks with action. Some of the areas where Government could focus more on include fair competition and promotion of Government bulk procurement from local SME suppliers.

IV. Formalisation of the SME sector

It was noted at the Symposium that the informal nature of the SMEs makes it difficult to discern their exact value and contribution to economic growth and hence makes it harder for policy interventions. When compared with registered SMEs, data showed that registered (and hence formal) SMEs appear to posit higher turnovers and are more dynamic than their unregistered counterparts. Formal SMEs are also better in terms of their contribution to the economy, including the fact that they create sustainable jobs and may also contribute to state tax revenues.

In this regard, therefore, Namibia was urged to create incentives for SMEs to register with relevant authorities and become formal businesses so that their value and contribution can be determined and developmental measures be channelled effectively. Such incentives could be in the form of free training services, targeting of formal SMEs through Government procurement policies, etc.

V. Capacity building

Entrepreneurial training in the SME sector

It was noted that there is still shortage of skills and capacity in the SME sector; hence Government was called upon to ensure the provision of skills and capacity. In New Zealand, Government encouraged adults to attend entrepreneurial training by granting them tax rebates during the year they attend such training. Adults were particularly targeted because of their influence in their younger relatives' career choices. This entrepreneurial campaign has proven to be a success as it has created a strong SME base in that country.

Government can take advantage of the existing infrastructures such as that of the Polytechnic of Namibia. The Polytechnic school of entrepreneurship currently has a small incubator facility which shields new businesses from some of the hindrances and formal procedures that businesses can face upon starting up. The idea could be to have such an incubator at a larger scale, a sort of "one stop-shop" that carter for all SMEs needs.

Mentoring and coaching facilities

The Symposium noted that SME development in Namibia was challenged by the lack of mentoring, coaching and supporting facilities. Nonetheless, another view was expressed that SMEs were also reluctant to utilize the available facilities. In this connection, SMEs were urged to seek and invest in available training and mentorship programmes to build capacity in running their businesses. SMEs were also urged to join the Namibia National Chamber of Commerce and Industry for a greater network and take advantages of the existing similar facilities.

At the macro-level, Namibia was urged to promote the concept of business angel network. An angel investor (also known as a business angel or informal investor) is an affluent individual who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity. The country was urged to devise these SME support networks mechanisms targeting specific sectors of interest rather than trying to support every SME business.

A small but increasing number of angel investors in mostly developed countries have organized themselves into angel groups or angel networks to share research and pool their investment capital. The successful examples cited in this regard include the energy financial support in Russia. Furthermore, business angel networks have helped a number of SMEs in the UK to grow and expand. It is, however, necessary to ensure that any adoption of such strategies that are successful elsewhere are fine-tuned to suit local specifics and needs.

Entrepreneurs were further encouraged to embrace partnerships because a good innovator may not necessarily be a good implementer at the same time. International experience also showed that businesses with more than one owner/manager perform better than a sole trader.

VI. Ease of doing business in Namibia

The Symposium took note that doing business in Namibia remained relatively difficult, particularly for SMEs. The procedure is long and complicated and eventually discourages prospective entrepreneurship. In this connection, the Government was urged to have a sort of "one stop-shop" for all procedures and formalities needed to do business in Namibia.

VII. Creation of Business support institutions

Namibia is urged to establish various institutions to guide the development of businesses in the country, including SMEs. Government was urged to avail funds for their establishment and sustenance. The recommended institutions include an Economic council, a Business angel network and private sector Credit Bureaus.