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The Impact of Microfinance Service Delivery on the Growth of SMEs in Uganda

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EXECUTIVE SUMMARY

This policy brief examines the impact of microfinance service delivery on the growth of small and medium-sized enterprises (SMEs) in Eastern Uganda. The objectives of the study were as follows: Establish whether MFIs service delivery lead to growth of business capital and stock accumulation; determine the affect of growth of employment of the business; influence of socioeconomic characteristics on the growth of SMEs; and realize the constraining factors to accessing Microfinance Institutions (MFIs) services by SMEs. The study used a cross-sectional design combining both quantitative and qualitative data analytical methods. The multiple regressions and the Logit model were used in the process of estimating impact of MFIs on the growth of SMEs.

The findings indicate that although the MFIs have performed below the average expectations due to some industry-wide challenges, they have had an impact in linking SMEs and the poor to sources of credit. There is a positive relationship between the provision of microcredit and the growth of SMEs in terms of growth of business capital and stock accumulation.

Location, gender of the owner, education levels, age of the business and default history of the client are all socio-economic characteristics that play a key role in the growth of SMEs. The findings also indicate that constraints that affect SMEs in accessing MFIs products included levels of education of the business owner, time period the business has been in existence, initial amount of business capital, assets owned before the loan, liabilities before the loan, the availability of collateral, location of the enterprise and loan and default history.

The study recommends formulating a strategic plan related to the prudential operation and management of SMEs and the MFIs. Establishing an SME authority could create a powerful single-point management structure, which would address challenges affecting SMEs through an institutionalized public-private partnership.

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INTRODUCTION

The major challenge facing many developing countries, especially in Africa, is devising appropriate development strategies that will capture the financial services instruments to support SMEs, which constitute about 70 percent of the business sector and are responsible for employing 56-70 percent in Uganda. Delivery of microcredit to operators of SMEs in developing countries is increasingly being viewed as a strategic means of assisting the so-called "working poor".

In the last 25 years, the delivery of financial services to SMEs has been considered an important tool for poverty reduction through provision of job opportunities. This is part of the Millennium Development Goal (MDGs) to alleviate poverty where MFIs can contribute tremendously, as argued by Hiderink et al (2009). Moreover, the main challenge facing the poor is to gain financial power to enable them to boost their income generating activities since accessing finance is pivotal in the struggle to reduce poverty (Yunus, 2003; Kasekende and Opondo 2003).

The microfinance industry worldwide has been recognized as an instrumental tool for poverty alleviation and economic growth. Socio-economic transformation efforts of low-income and poor communities have been possible through accessing semi-formal and informal financial products and services. This plays a key role in determining the size of the firms (MFPED 2008). Indeed, microfinance can help in providing start-up and business expansion capital, among other financial services. The industry is seen as paramount in augmenting private sector-led growth through supporting the SME sector.

In Uganda, the microfinance industry is meant to play a critical role in providing a range of small financial and non-financial products to its clients. This includes loans, financial education, and a wide spectrum of crosscutting issues like the fight against HIV/AIDS and environmental protection. Such a range of services could spur SME growth. For a number of years, SMEs have gained support from the MFIs, but it still remains unclear whether their management practices and services rendered by the MFIs support their efforts or create additional hurdles for SMEs to grow their businesses. Over the past decades, a considerable amount of aid has been channeled into microfinance programs in Uganda to help finance the growth of the private sector, especially SMEs, with varying degrees of success. Like all development interventions, studies that ascertain the achievements and failures of these funding programs would help a lot for future funding design. This study is intended to establish the impact of microfinance service delivery on the growth of SMEs in Uganda.

> **Uganda needs to create the necessary institutional and regulatory framework environment for both SMEs and MFIs to overcome access problems and constraints.**

RESULTS

Our results demonstrate that there is positive association between SME's growth, in terms of increase in business capital, and stock with MFIs activities. The amount of capital that is borrowed by SMEs and the length of the repayment period are significantly correlated. The growth of stock accumulation is positively associated with the amount of the loan borrowed, adequacy of the loan, interest rate paid and the number of times the SME has borrowed. Ninety-one percent of the SMEs surveyed borrowed money from MFIs to buy raw materials for their businesses, which implies an expansion. The result further show that an increase in the amount borrowed by 1,000,000 Uganda Shillings (approx. USD 400) leads to stock accumulation by about 141.5 percent.

Microfinance Services and SMEs Employment Growth

The SMEs' non-financial activities are measured by change in level of employment. The results show that 34 percent of respondents from SMEs used part of the loan from the MFIs for operational cost –hiring additional units of labor to help run SMEs. The findings show that the loan repayment period and adequacy of the loan significantly influence the decision by SMEs to hire extra labor. The loan repayment period is positively associated with employment generation. For instance, if the loan repayment period is raised by one year, SMEs could raise the level of employment by about 26.4 percent. However, the interest rate charged on the loan negatively impacts on the ability of SMEs to hire additional units of labor. Other variables like adequacy of the loan borrowed and time it takes to process the loan also negatively affects the SMEs' employment generation abilities. Nevertheless, non-financial services offered by MFIs like advisory, training and counseling impact negatively on employment generation expectations of SMEs.

The Effects of Socio-Economic Characteristics on the Growth of SMEs

The socio-economic characteristics of SMEs (location, level of education, source of business capital, age of business, and default history) play an important part in enabling their growth. The results show that there is a significant correlation between growth of SMEs and the characteristics like location of a business, source of business capital and level of education of the SME manager. For instance, a change from rural to urban setting would increase employment levels by 18.7 percent.

Constraints to SMEs' Access to MFI Services

The constraints of SMEs in accessing MFIs services ranged from location, ownership, highest level of education, time period the business has been in existence, amount of business capital, assets owned before the loan, liabilities before the loan and loan history of the client. For example, the level of education influenced access to MFIs services significantly where borrowers with university education had 8 points more chances of accessing the loan compared to their counterparts without. Similar trend analysis showed the same results in terms of history of paying back, location, interest rate, purpose of the loan and type of ownership of the business. The interest rate charged on the loan was also a constraining factor on access to microfinance services. This implies that the cost of the loan was downplayed by borrowers concentrating on the pressing need for the loan.

CONCLUSION

Microfinance plays a central role in the growth of microenterprise, but this is only possible if it is accessible and reasonably priced. SMEs are increasingly seen as playing a strategic role in economic growth, despite experiencing difficulties in accessing financial and non-financial products from MFIs. Some of the reasons include limited levels of education to provide management and technical skills, lack of collateral, poor technology, poorly located enterprises and sometimes limited market. In cases where SMEs succeed in accessing financial resources, the interest rate is high, which sometimes lead to high default rates or non-performing loans. This calls for a need to overcome constraints that impede SMEs access to financial resources. Uganda, therefore, needs to create the necessary institutional and regulatory framework environment for both SMEs and MFIs to overcome access problems and constraints.

POLICY RECOMMENDATIONS

Establishing the SME Authority and Inter-institutional Coordination

Existence of supporting institutions in Uganda, such as the *Microfinance Outreach Plan and Association of Microfinance Institution of Uganda* (AMFIU) does not guarantee the effectiveness of the whole support system. Evidence from the field survey shows where there is a range of support institutions, effective financial and non-financial support is often not available. In view of the aforementioned, certain strategies are needed to enhance the quality of institutional support for SME growth.

Establishing an SME Authority would create a powerful single-point administrative structure, which cuts across administrative and financial barriers and fully implement policy and other actions affecting SMEs. The Authority should have powers to formulate policy, expedite approvals from other government agencies and resolve issues encountered during implementation of agreed actions. In operational terms, the Authority should be an independent body and should function as a "one stop shop" that could coordinate and facilitate information delivery to SMEs. This recommendation is in line with two successful organizations in Serbia and the United States set up by law to support the development of SMEs.

Inter-Institutional coordination that is in line with the Uganda National Development Plan is essential and needs to be put in place and operationalized. It should have clear strategies to provide SMEs with technical skills and financial resources to enable implementation of the strategies in a timely, efficient and effective manner. Coordination among several ministries and local governments is necessary to achieve the outcomes of a well-thought-out strategy. The strategy needs to be integrated into the national policy in other sectors. There is need for an SME Policy Unit that should act as interim measure to facilitate effective coordination. This can be done through categorization and regulation of all SMEs.

Institutionalized Public-Private Partnerships (PPPs)

Addressing challenges affecting SMEs requires institutionalized public-private partnership involving government and the private sector including business association. This could be done through mechanisms that strengthen business associations, improved access to finance for SMEs promotion of business development services and improved information dissemination on available initiatives.

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