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The Role of Small Businesses in Poverty Alleviation: The Case of Dar es Salaam, Tanzania

Raymond Mnenwa
&
Emmanuel Maliti

RESEARCH ON POVERTY
ALLEVIATION

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in Poverty Alleviation:
The Case of Dar es Salaam, Tanzania**

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Abbreviations

CTI	Confederation of Tanzania Industries
GDP	Gross Domestic Product
ILO	International Labour Organisation
ILFS	Integrated Labour Force Survey
MEs	Micro-Enterprises
OLS	Ordinary Least Squares Method
2SLS	Two-Stage Least Squares Method
SSEs	Small-Scale Enterprises
SMEs	Small and Medium Enterprises
TShs	Tanzanian Shillings
UNDP	United Nations Development Programme

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ABSTRACT

By using a sample of 225 manufacturing small businesses employing between one and ten employees, this study investigates whether the profits, salaries and jobs created by small businesses contribute to poverty alleviation.

The data gathered supports the hypothesis that small businesses do contribute to alleviating poverty. Results show that average incomes generated by surveyed businesses (both profit margins and salaries) were above the basic and food poverty lines, much more for small-scale enterprises than micro-enterprises.

Business performance in terms of profit generation and employment creation was also positively related to the size of the firm, suggesting that strategies which promote vertical growth are more favourable than those which promote horizontal growth.

Moreover, socio-economic factors were found to positively influence profit margins and employment creation. These factors included the business owners' gender, level of education, motivations for establishing their businesses, sources of initial capital, and the technology used. Finally, findings indicated that the potential to generate profit lies mostly with formal firms compared with informal enterprises.

Suggested keywords: Tanzania, small business, emerging business, SME, SSE

EXECUTIVE SUMMARY

Introduction

The role of small business in poverty alleviation and economic growth has emerged as an important topic not only for policy makers but also for academic research. The importance of small business arises in view of the dismal performance of previous policies that emphasized large-scale industrialization. Despite conflicting evidence obtained in several studies, it is generally agreed that encouraging the development of small businesses is one way of fostering growth and alleviating poverty. This debate has prompted the authors to investigate the role of small businesses in poverty alleviation focusing on the Dar es Salaam region.

Literature Review

The examination of the relationship between small business, economic growth and poverty alleviation is an expanding field of research. Several studies have supported the role of small businesses in economic growth, job creation and poverty alleviation. Such studies include one by Gebremariam *et al* (2004) which demonstrated a positive relationship between small business and economic growth; and Birch (1979) who found that 80% of the jobs created between 1969 and 1976 in the US resulted from the activities of small businesses. In Tanzania, Small and Medium Enterprises (SMEs) were estimated to account for a significant share of GDP – up to 35% and employ about 20% of the labour force¹.

Studies such as Biggs *et al* (1998), Lugalla (1995), and Musonda and Kweka (1998) have indicated that factors such as education, capital etc have an influential role on firm performance. Unfortunately, some of these analyses did not assess how these determinants of firm growth affect the contribution of small businesses to poverty alleviation. Some researchers have generated results that small businesses do not have a positive role in growth and poverty alleviation, and so further investigation is necessary².

The Survey

The survey was conducted in Dar es Salaam in October 2004 to establish the link between small businesses and poverty alleviation. Three areas were covered:

- i) The role of small businesses in poverty alleviation using four core variables: namely, sources of disposable income, profit margins, salaries and employment creation;
- ii) The socio-factors influencing profit and employment creation, and
- iii) The impact of business formality on profit margins and employment growth.

During the survey 225 respondents were interviewed using a semi structured questionnaire.

¹ Wangwe, 1999

² Beck et al., 2003 and Davis et al., 1993

RESULTS AND ANALYSIS

Contribution of Small Businesses to Poverty Alleviation

Source of Disposable Income: A majority of the small business (87%) ranked small businesses as their top source of income out of which 84% were owners of Micro-Enterprises (MEs) and 94% were in Small-Scale Enterprises (SSEs). Furthermore, a majority of the respondents (60%), ranked income from small business as their number one source, indicated at the same time, an improvement in their standard of living while only 29% of them experienced a declining living standard.

Employment Creation: Employment growth occurred within SSEs i.e. three employees per SSE over an average period of 6 years, while MEs did not increase their employment levels; giving an overall annual employment growth of 4.2%. Although this proves that the bigger the firm, the higher the potential for expanding employment; the percentage of firms with declining or static employment was higher than the percentage of firms that increased their employment levels. Within the period of six years, only 14.8% of the firms which started as MEs managed to graduate to SSE, further indicating the limited potential of small business to increase employment.

Salaries, Profit Margins and Profitability Trend: Analysis shows that salary levels and profits varied with the size of enterprises. SSEs offered higher monthly salary levels compared to MEs. For both MEs and SSEs, salaries earned were well above both the basic need and food poverty lines. Moreover, SSEs generated more profits compared to MEs. Regarding profitability trends, the majority of small businesses were less likely to attain growing profitability as 56% indicated either declining profitability or static profits. In this case, the potential for small businesses to alleviate poverty appear to be further limited by the lack of overall improvement in profitability.

Socio-economic Factors Influencing the Contribution of Small Businesses to Poverty Alleviation

Gender: The results show that male-owned enterprises possess higher potential for profit generation compared to female-owned businesses. Similarly a large proportion of the male-owned firms had increased employment levels compared to the proportion of female-owned firms. Although a majority of both men and women had not completed education above secondary level, the results show that more male entrepreneurs (13%) had acquired certificates, diplomas or university degrees, compared to female entrepreneurs (6%).

Education: Entrepreneurs educated above secondary school generated more profit than those with lesser education. This is the same with those entrepreneurs trained for more than one year when compared to those with less than a year of training. Regarding growth in employment, the majority of entrepreneurs with higher than secondary education increased their employment. Thus, although participation in training programmes was not a necessary condition to employment growth; a longer duration of training appeared to have contributed to employment growth.

Motivations: The study shows that while most of the small businesses were motivated by push factors, firms motivated by pull factors demonstrated more potential to generate higher profits. For the case of employment levels and growth, push factors were dominant among owners of MEs, while two-fifths of the SSEs owners were influenced by pull factors. At the same time majority of firms established out of pull factors experience employment growth contrary to the majority of push factor firms which either did not register employment growth or declined over time.

Sources of Initial Capital: Businesses which sourced capital from personal savings as well as profits from other businesses generated higher profits than businesses which accessed capital from other sources. Almost all of the businesses surveyed (96.6%) sourced capital from personal or family savings, loans from friends, or profits from other businesses. Only 2% of the firms had access to formal financial institutions showing the need to address those factors which limit access to formal financial sources.

Activities of Owners Before Starting Their Businesses: The study shows the existence of a strong level of entrepreneurship among SSE owners. Owners of MEs were relatively more likely to have been unemployed prior to their current businesses compared to SSE owners. The majority of the firms with owners possessing prior business experience managed to increase their employment levels. However, being employed, unemployed or attending schooling prior to the current business did not contribute to the increase in employment levels.

Formality, Profit Margins and Employment Levels

The study utilized three attributes of formality – business registration, licensing and tax payments to establish the impact of formality on profit margins and employment creation. Most of small businesses were within the margin between formal and informal sectors. While 31% of the respondent MEs had virtually none of the formality attributes, only 13% of the SSEs did not possess any of the attributes of formality.

Business Registration, Profit Margins and Employment Creation: A majority of firms generated profits whether registered or not. However, the percentage of registered enterprises which generated profit and experienced employment growth was higher than the percentage of unregistered enterprises. Furthermore, a large percentage of unregistered firms had not grown or have declined over time compared to registered firms.

Business Licensing, Profit Margins and Employment Creation: Most enterprises generated profit whether licensed or not. However, the percentage of licensed firms that generated profit was higher than the percentage of unlicensed firms. In terms of employment growth, a majority of the licensed firms registered growth while a large percentage of unlicensed firms had not grown or had declined over time compared to licensed firms.

Tax Payments, Profit Margins and Employment Creation: Similar to the cases above, most of the enterprises generated profit whether they paid tax or not. However, the percentage of tax-paying enterprises generating profit was marginally higher than the percentage of those which did not pay taxes. As for the registration and licensing categories, similar results were found when taxation was linked to employment growth.

Overall, the study shows that the potential to generate higher profit lies mostly with formal firms compared to informal enterprises. However, further findings indicated that although formality might have an influence on profit generation and employment growth, it was not capable by itself to enable small businesses to increase their performance.

Emerging Policy Conclusions

Although many SMEs have been established over the last two decades, poverty has continued to be a major characteristic of many people in the country. This raises the question of whether SMEs play any role in poverty alleviation. Is the creation of survivalist enterprises an effective poverty

alleviation strategy? This study shows that majority of small businesses earned little and their impact on employment growth is limited.

As Broembsen, 2003 indicated given the characteristics of the market in which MEs operate, i.e., low income, low value-added activities, fierce competition and over-trading, a deliberate strategy to replicate these kinds of businesses simply threatens existing businesses and results in insecurity for existing entrepreneurs. This study shows that business performance in terms of profit generation and employment creation is positively related to the size of the firm, suggesting that strategies that promote vertical growth are more favourable than those promoting horizontal growth.

1. INTRODUCTION

1.1 The Study

The role of small business in poverty alleviation, economic growth and job creation has emerged as an important topic not only for policy makers but also for academic research. The importance of small business arises in view of the dismal performance of previous policies that emphasized large-scale industrialization. Recent economic reforms have also created opportunities for the fledgling small businesses, and thus generated interest in small business research initiatives. It is generally agreed that encouraging the development of small businesses is an effective way of fostering growth and alleviating poverty, despite conflicting evidence obtained in several studies. This debate has prompted the authors to investigate the role of small businesses in poverty alleviation in Dar es Salaam, Tanzania.

The study adopted three major approaches:

1. Firstly, to gauge the direct role of small businesses in poverty alleviation, the following major variables were analyzed: 1) sources of disposable income (ranking); 2) profit margins, remuneration to employees, and profitability trends; and, 3) employment creation.
2. Secondly, critical socio-economic factors influencing the contribution of small businesses (in terms of profits and employment levels) to poverty alleviation were assessed.
3. Thirdly, small business formality was investigated by examining business registration, licensing and taxation, and how these factors influenced employment levels and profit margins. The premise was that higher levels of profitability and growth were possible for formal firms, which operated at higher levels of risk than informal firms.

1.2 Limitations of the Study

Though the findings and conclusions are not affected, it is important to highlight some limitations of this study. First, the survey was only conducted in the Dar es Salaam region hence, it does not examine regional variations in Tanzania. Secondly, as with most surveys, the study only captured the circumstances prevailing at the time of the interviews. Thirdly, it is also possible that some entrepreneurs did not provide their true opinions during the interviews because they regarded some of the questions as sensitive. However, this group was small and we assume did not affect the overall results and conclusions.

1.3 Organisation of the Report

The report is organised as follows. Chapter 2 reviews the relevant literature. Chapter 3 describes the hypothesis to be tested and the significance of the study, and chapter 4 presents the research methodology used. Chapters 5 to 7 present and discuss the results of the empirical analysis, and chapter 8 explores the relationship between business formality, profit margins and employment levels. Chapter 9 discusses whether small business policy in Tanzania is based on evidence obtained from research. Finally, chapter 10 makes suggestions for further research.

2. LITERATURE REVIEW

The examination of the relationship between small business, economic growth and poverty alleviation is an expanding field of research, frequently featuring in development policy studies. It is generally agreed and well documented that small businesses have a positive role in poverty alleviation. Small businesses have long been regarded as crucial for the achievement of broader development objectives, including poverty alleviation, economic development and the promotion of more democratic and pluralist societies³. People on low incomes can augment their incomes by engaging in small business activities⁴. Small business ownership can also facilitate greater self-determination and empowerment of poor people as a consequence of owning and controlling resources.

Several studies have supported the role of small businesses in economic growth, job creation and poverty alleviation. Using both OLS and 2 SLS regression analysis, Gebremariam *et al* (2004) demonstrated a positive relationship between small business and economic growth. Furthermore, they found that a strong relationship also existed between the incidence of poverty, small business and economic growth. Relative to job creation, Birch (1979) found that 80% of the jobs created between 1969 and 1976 in the US resulted from the activities of small businesses, and it was estimated that Small and Medium Enterprises (SMEs) employed 22% of the adult population in developing countries⁵. In Tanzania, SMEs were estimated to account for a significant share of Gross Domestic Product (GDP) – up to 35% – and to employ about 20% of the labour force⁶. These results mostly lead to the conclusion that, by creating jobs, small businesses play a critical role in poverty alleviation.

Biggs *et al* (1998) evaluated how determinants, such as education and capital, contributed to firm performance. They found that firm growth was greater when the manager or owner of the firm had completed secondary education or university, and it was even higher when the owner had some technical education. In Tanzania, several studies focusing on SMEs, such as Lugalla (1995), and Musonda and Kweka (1998), have assessed the effects of several determinants on firm growth such as the level of education of entrepreneurs, capital factors etc. However, the analysis did not assess how these determinants of firm growth affect the contribution of small businesses to poverty alleviation.

In relation to the policy environment in Tanzania, several studies⁷ have examined taxes and business licensing issues and how they act as constraints to successful business growth and operations. However, these studies were limited in terms of investigating how these policy factors influence the contribution of small businesses to poverty alleviation.

Some researchers have also generated results that small businesses do not have a positive role in growth and poverty alleviation, and so further investigation is necessary. Using the newly-built cross-country database on SMEs, Beck *et al* (2003) found that, while SMEs were a characteristic of fast-growing economies, cross-country analyses did not support the view that SMEs exerted a causal impact on long-run growth. A significant relationship between SMEs and poverty alleviation did not exist. Specifically, they found that the size of the SME sector was not associated with the income levels and growth of the poorest quintile of society, the percentage of the population living below the poverty line, or the poverty gap.

The relationship between small businesses and poverty alleviation and job creation has also been

³ UNDP, 1998

⁴ Sullivan, P., 1997

⁵ Fisseha & McPherson, 1991; Fisseha, 1992; Daniels & Ngwira, 1993

⁶ Wangwe, 1999

⁷ Bhalla, 1991; CTI, 2000; SwissContact, 2003; World Bank, 2004

questioned. Davis *et al* (1993) demonstrated that while the gross rate of job creation and loss of jobs was higher in small firms, there was no systematic relationship between net job creation and firm size. Hallberg, K (2001) also disputes the argument that SMEs are important for employment growth, indicating that apart from the fact that small businesses exhibit high birthrates and high death rates, in some countries (both developed and developing), net job creation rates (gross job creation less gross job destruction) do not exhibit a systematic relationship to firm size. In sub-Saharan Africa, Biggs and Shah (1998) found that large firms were the dominant source of net job creation in the manufacturing sector.

3. HYPOTHESIS AND SIGNIFICANCE OF THE STUDY

3.1 Hypothesis

The following are the major hypotheses to be tested:

- Small businesses play a significant role in poverty alleviation;
- Socio-economic factors influence the contribution of small businesses to poverty alleviation; and
- Business formality influences the contribution of small businesses on poverty alleviation.

3.2 Significance of the Study

Although relevant literature is full of references to small business, the problem of the poor performance of small businesses raises the question whether the role and dynamics of small businesses in poverty alleviation are fully understood by entrepreneurs and policy makers. Most studies, such as Musonda and Lwoga, (1997) and Wangwe, (1999), have tended to focus on general issues, such as constraints and the institutional and policy frameworks, without examining the link between small business and poverty alleviation. A significant part of this literature only analysed constraints (both at the enterprise level and macro-level) that face small and medium enterprises in Tanzania, and assumed that any small business activity contributed to poverty alleviation. Thus, the current study undertakes to establish the link between small businesses and poverty alleviation. Furthermore, previous researches on small businesses studied SMEs together, and, therefore, the direct contribution of SMEs employing less than 10 persons on poverty alleviation was not separately identified.

4. RESEARCH METHODOLOGY

This research considers the contribution of small businesses to poverty alleviation as a multi-faceted phenomenon. Consequently, the survey gathers data on a range of variables related to:

- 1) the role of small businesses in poverty alleviation;
- 2) socio-economic factors; and,
- 3) business formality.

4.1 Sampling Frame

Primary data were generated from a cross-sectional survey of small business firms. One round of interviews was conducted. The sampling frame for the survey consisted of firms employing less than ten people. Extensive interviews with the small businesses were conducted using a survey questionnaire covering both socio-economic and business information data. Only the business owners were interviewed.

Identification of the firms included in the sampling frame was done using deliberate systematic selection based on two criteria. First, the firm had to be in the manufacturing sector, and secondly it had to employ between one and ten employees, including the owner if he/she was actively involved in the business. Following Parker R. L (1995), the business firms were stratified according to type i.e. micro-enterprises⁸ (MEs) and small scale enterprises⁹ (SSEs). From each stratum, firms were randomly sampled i.e. 162 MEs and 63 SSEs.

Thus the total sample covered 225 small businesses in the three districts of Dar es Salaam: Temeke (34 businesses), Kinondoni (129 businesses) and Ilala (62 businesses). The analytical methods used in the study will now be briefly described.

4.2 Data Analysis

Analysis of the Role of Small Businesses in Poverty Alleviation

The role of small businesses in poverty alleviation was the primary theme of the research, and was analyzed using descriptive statistics (means and percentages). Results generated were used to reject or accept the first hypothesis. Four core variables were covered in this analysis:

- i) Entrepreneurs' sources of disposable income (ranked according to importance).
- ii) Income generation in terms of profit margins. Respondents were asked to estimate their monthly revenues and costs, from which their profit margins were calculated. The guiding principle for this part of the analysis was the level of income that was perceived by respondents to be poverty reducing.
- iii) Income generation in terms of salaries and wages for employees. The same principle regarding the level of income was applied here.
- iv) Employment creation. The data were tabulated and analyzed using means and percentages.

⁸ 'MEs' refers to small businesses employing 1 to 5 employees.

⁹ 'SSEs' refers to small businesses employing 6 to 10 employees.

Analysis of the Factors Influencing Profit and Employment Creation¹⁰

In addition to the analysis of sources of disposable income, profit margins, employment creation and salaries, the socio-economic factors with the potential to influence on profit and employment creation were examined. Descriptive statistics were calculated to assess these factors.

Analysis of the Formality of the Business

Three major attributes of business formality – registration, licensing and tax payments – were studied to establish the impact of business formality on profit margins and employment growth. Descriptive analysis was performed by cross-tabulating the attributes of formality, with profits and employment growth.

¹⁰ For employment creation, analysis focused on two variables i) employment levels, and; ii) employment growth

5. CONTRIBUTION OF SMALL BUSINESSES TO POVERTY ALLEVIATION

To assess the role of small businesses in poverty alleviation, four core variables were examined: entrepreneurs' sources of disposable income, income generation in terms of profit margins, income generation in terms of salaries and wages for employees, and employment creation.

5.1 Source of Disposable Income

Major findings

- Small businesses were ranked as number one source of income
- 60% of respondents indicated an improvement in their standard of living
- 29% of the respondents experienced a declining standard of living, while 11% saw no change

The assessment of the role of small businesses in poverty alleviation commenced by looking at the position small businesses occupied as a source of disposable income. Table 1 show that 87% of the respondents ranked small businesses as their top income source. For those who ranked small businesses as number one source of income, 84% were micro-enterprises (MEs) and 94% were small-scale enterprises (SSEs).

Table 1: Ranking of Sources of Income

Primary Source of Income	Micro Enterprise		Small Scale Enterprise		All	
	Number	%	Number	%	Number	%
Small businesses	136	84	59	94	195	87
Employment elsewhere	19	12	4	6	23	10
Family remittances	7	4	0	0	7	3
Total	162	100	63	100	225	100

The importance of income from the small businesses is further emphasised by the fact that a majority of respondents, as shown in Table 2, were not engaged in other occupations, implying that these small businesses were their sole source of income. This finding also correlates with the findings on the owners' motivations for starting small businesses (see Table 12) where 'push' factors dominated over 'pull' factors signaling a higher probability that income from these establishments would be highly ranked.

Table 2: Number and Percentage of Respondents With Other Occupations

	Micro Enterprise		Small Scale Enterprise		All	
	Number	%	Number	%	Number	%
No other occupation	97	60	31	49	128	57
Salaried employment	13	8	2	3	15	7
Other businesses	52	32	30	48	82	36
Total	162	100	63	100	225	100

To determine if income derived from small businesses was poverty reducing, respondents' perceptions of their standard of living were examined for those who ranked small businesses as the number one source of income. The results of this exercise are presented in Table 3. A majority of respondents (60%), who ranked income from small business as their number one source, indicated an improvement in their standard of living, while 29% experienced a declining standard of living, and 11% reported no change.

Table 3: Respondents' Perceptions of Living Standard Relative to Income Source

Living Standard	Micro Enterprises		Small Scale Enterprises		Total	
	Number	%	Number	%	Number	%
Better today	41	67	76	57	117	60
Worse today	14	23	43	32	57	29
Same	6	10	15	11	21	11
Total	61	100	134	100	195	100

These results provide an insight into the perceptions of small business owners on the potential of these businesses to alleviate poverty. Importantly, the results acted as the basis for further analysis.

5.2 Employment Creation

Major findings

- Potential for employment creation correlates with firm size
- Levels of employment for most MEs were static compared to SSEs
- The percentage of firms with declining or static employment was higher than the percentage of firms that increased their employment levels

Small businesses in developing countries have been long recognised to play a dynamic role through which employment growth can be achieved. Apart from the fact that employment growth is a

measure of economic growth¹¹, for the entrepreneur, it can also serve as an indicator of his/her success and, for the company as a whole, it is a measure of the economic contribution of the firm to the common good¹². Moreover, according to Child (1973), employment is an adequate criterion for the measurement of the size of an organisation, because it is above all human beings who are 'organised'.

This study assessed the ability of small businesses to generate employment opportunities. Table 4 shows that MEs employed on average three employees while SSE employs twice as many. Findings further show that employment growth occurred within the SSEs i.e. three employees per SSE over an average period of 6 years¹³ in operation, while MEs did not increase their employment levels¹⁴; giving an overall annual employment growth of 4.2% as indicated in Table 4.

Table 4: Average Number of Employees per Enterprise and Employment Growth

Business Type	Observations	Number Employees at Commencement	Number Employees at Time of Interview	Average Change	% Growth
Micro Enterprises	162	3	3	0	0
Small Scale Enterprises	63	6	9	3	8.3
Overall	225	4	5	1	4.2

Three conclusions can be made from these results:

- i) the bigger the small business firm, the higher the potential for expanding employment;
- ii) overall, the small business sector possesses limited capacity to expand to absorb surplus labour; and,
- iii) the principle focus of MEs is often on 'survival', while 'growth' might be the major focus of SSE irrespective of the hurdles in the business environment.

We also observed that 41%, 31% and 28% of the interviewed firms recorded increasing, decreasing and no change in employment, respectively. Combining the percentages of firms with static employment (28%) and those with decreasing employment (31%) shows the inability of the small business landscape to expand employment. Furthermore, only 14.8% of the firms which started the period as MEs managed to graduate to the SSE category, further indicating the limited potential of small business to reduce poverty.

¹¹ Kirchoff, 1991

¹² Dunkelberg and Cooper, 1982

¹³ Small businesses were in business for differing durations with an average of six years.

¹⁴ On the basis of Kirchoff (1991) argument, this will mean that MEs did not contribute to economic growth compared to SSE.

5.3 Income Generation for Employees

Major findings

- Salaries paid to employees were above both the food and basic need poverty lines
- Low salaries signalled low job quality in the small business landscape
- Higher salaries correlated positively with the size of the enterprise

To analyse income generation for employees, this study focused on salaries earned by people employed in small businesses. The respondents were requested to indicate salaries and wages. 151 respondents answered this question. Table 5 shows that salary levels varied with the size of enterprises. SSEs offered higher salaries of about TShs 50,000 per month, compared to TShs 32,000 offered by MEs.

This result was consistent with results from Beck, T *et al* (2003) which indicated that large firms offered higher wages and more non-wage benefits than small firms in developed and developing countries, even after controlling for differences in education, experience and industry. As remuneration is one of the indicators for job quality, Tibandebage, P. *et al* (2001) demonstrated the existence of low levels of job quality in the small business sector through an analysis of the remuneration, social protection, working conditions, human resource development and organisation in this sector. In income terms for both MEs and SSEs, salaries earned were well above the estimated basic need poverty line of TShs 9,203 per month, as well as above the food poverty line estimated for Dar es Salaam region¹⁵.

Table 5: Monthly Salaries for Small Businesses Employees (Tshs)

Wages and Salary	Micro Enterprise (number = 101)	Small Scale Enterprise (number = 50)	All (number = 151)
Mean wages and salaries	31,648	49,989	40,818
Standard deviation	14,820	28,245	21,533
Maximum	90,000	100,000	100,000
Minimum	9,000	15,000	9000

5.4 Profit Margins and Profitability Trend

Major findings

- Firm size correlated with profit generation i.e. SSEs generated more profits compared to MEs
- Overall, small businesses generated profits above the average salaries

¹⁵ The basic food poverty lines for the Dar es Salaam region as estimated by Household Budget Survey 2000/01 is Tshs 6,719 per month (adult equivalent for 28 days) HBS Table 7.1, page 78.

As the majority of small business owners were not involved in other income-generating activities¹⁶, the estimated profit margins represent a better proxy for the disposable income of surveyed entrepreneurs. The respondents were also requested to comment on their profitability trend since the start of their businesses up until the time of interview. Profit margins for both MEs and SSEs are presented in Table 6, where 214 respondents answered this question. Profits for MEs ranged between TShs 5,000 and TShs 900,000 per month, and averaged TShs 137,600, while SSEs' profits ranged from TShs 6,000 to 2,500,000 per month with an average of TShs 465,887.

Table 6: Monthly Profit Margins (TShs)

Profit Margin	Micro Enterprise (number = 152)	Small Scale Enterprise (number = 62)	All (number = 214)
Average profit	137,473	465,887	301,680
Std. deviation	152,432	604,657	378,544
Maximum	900,000	2,500,000	2,500,000
Minimum	5,000	6,000	5,500

The lower profits for MEs were attributed to the lower scale of their business operations as evidenced by low investment capital (the majority of respondents, as discussed later, established small businesses due to a lack of other employment opportunities). The overall average profit margin for both the MEs and SSEs was estimated at TShs 378,544 per month, which was higher than the average salary in the manufacturing industry which stood at TShs 103,407¹⁷. The results conform to the occupational choices models¹⁸, which describe how individuals decide to become entrepreneurs by comparing the wage they can earn from other employment with the entrepreneurial rent¹⁹ they can obtain by managing their own business²⁰. Opting for alternative employment will lead to a high probability of earning a minimum salary in the labor market given that the majority of entrepreneurs had a primary school level of education²¹.

Two observations can be made here on the role of small business on poverty alleviation:

- i) the majority of the surveyed businesses generated income above poverty lines; and,
- ii) most of the owners were not engaged in other income generating activities (57%)²².

In view of these findings, removing obstacles that limit vertical growth²³ may be more poverty alleviating than policy initiatives that emphasise horizontal growth²⁴.

Entrepreneurs were then asked to comment on their businesses' profit trends from when the business started to the time of the interview. Table 7 records their responses. The results indicate that 44% of respondents generated more profit over time, with no major differences in findings based on the firm's size.

¹⁶ Table 2

¹⁷ ILFS 2001

¹⁸ Lucas, 1978; Oi, 1983; Blanchflower and Oswald, 1990; Jovanovic, 1994

¹⁹ Entrepreneurial rent refers to benefits in terms of profit, social status, power and authority over employees.

²⁰ In their most basic form these models predict that an individuals' propensity to become self-employed is positively influenced by his/her managerial abilities, and negatively by the expected wage that could be earned as a worker.

²¹ Table 10

²² Table 2

²³ Vertical growth refers to business expansion within the same enterprise i.e. growth in size of firms.

²⁴ Horizontal growth refers to business expansion by establishing new more similar enterprises i.e. growth in number of firms.

Table 7: Perceptions of Business Profitability Trend

Profitability	Micro Enterprise		Small Scale Enterprise		All	
	Number	%	Number	%	Number	%
More profitable	71	44	29	46	100	44
Less profitable	60	37	25	40	85	38
No changes	31	19	9	14	40	18
Total	162	100	63	100	225	100

However, more MEs (19%) indicated no changes in profitability compared to 14% of SSEs. Combining 'less profitability' and 'no changes in profitability' shows that the majority of small businesses were less likely to attain growing profitability as 56% of the respondents indicated either declining profitability or static profits. Therefore, in this case, the potential for small businesses to alleviate poverty appears to be further limited by the lack of improvement in profitability.

To determine the relationship between profit trends and employment growth, profitability trends were cross-tabulated with data on employment growth (see Table 8). The results show that that only 49% of the firms which perceived growing profitability, registered employment growth, while 42% of these firms did not grow in terms of employment levels.

Table 8: Profitability Trends Relative to Employment Growth

	No Growth		Growth		Declining	
	Number	%	Number	%	Number	%
More profitable	51	42	45	49	4	36
Less profitable	44	36	35	38	6	55
No change	27	22	12	13	1	9
Total	122	100	92	100	11	100

5.5 Conclusions

The results on the contribution of small businesses to poverty alleviation show that, income from small businesses contributes to poverty alleviation. In this case, the hypothesis that small businesses have a role to play in poverty alleviation is accepted. However, the capability of small business to generate employment opportunities is low given that the percentage of firms with declining or static employment was higher than the percentage of firms that had increased the number of employees. Furthermore, only a small proportion of firms which started as MEs had managed to graduate to SSEs.

Profitability as a proxy for disposable income for entrepreneurs correlated with the firm size. The findings indicated that bigger firms have greater potential for poverty alleviation than small firms, i.e., the potential for poverty alleviation correlates with firm size. In this case, the principal focus of government policy relative to SMEs should be to improve the business environment, so as to facilitate vertical growth rather than horizontal growth as an indirect way to reduce poverty. The necessity for

this policy option is further evidenced by the fact that a substantial number of firms experiencing both positive profitability and high turnover²⁵ trends did not grow over time implying the existence of both firm-level and policy impediments that limit vertical growth.

²⁵ Turn over refers to volume of sales over a period of time (month in this case).

6. SOCIO-ECONOMIC FACTORS INFLUENCING THE CONTRIBUTION OF SMALL BUSINESSES TO POVERTY ALLEVIATION

The contribution of small businesses in terms of profit margins can be influenced by a number of critical factors. Critical factors influencing profit margins were identified. The factors identified and examined in the current study include the business owners' sex, education, motivations for starting their businesses, sources of initial capital, and technology used.

6.1 Gender of Small Business Owners

Major findings

- Ability to generate profit was influenced by gender of owners
- A majority of male entrepreneurs perceived better profit trends compared to female entrepreneurs
- Male-owned businesses generated more profit than female-owned businesses
- Education level and experience were the major factors explaining the gender differences in profit generating performance

Recent empirical studies on small businesses have incorporated a gender perspective through identification of certain gender specific traits of entrepreneurs. Gender factors not only affect the performance of small businesses, but also influence the choice of business opportunities²⁶. In this study, the effects of gender were assessed by comparing profits generated by various small businesses and the basic poverty line. Table 9 presents the analysis of profits generated by gender of the business owner.

When asked their perceptions on the performance of their business ventures, 47% of male entrepreneurs indicated that their businesses had been more profitable, compared to only 30% of the female entrepreneurs. These results imply that male-owned enterprises possess higher potential for profit generation compared to female-owned businesses.

Table 9: Perceptions of Business Performance by Gender ²⁷

	Male		Female		Group ²⁷		All	
	Number	%	Number	%	Number	%	Number	%
More profitable	85	47	11	30	4	57	100	44
Less profitable	67	37	16	43	2	29	85	38
No changes	29	16	10	27	1	14	40	18
Total	181	100	37	100	7	100	225	100

²⁶ OECD, 2004

²⁷ Group refers to business enterprises that were owned by more than one person with different sex.

Education was found to be the main factor explaining profit generation. Generally, as shown in Table 10, a majority of both men and women had not completed education above secondary level.

Table 10: Education Levels of Small Business Owners

	Male		Female		Group		All	
	Number	%	Number	%	Number	%	Number	%
No formal education	4	2	1	3	0	0	5	2
Primary education	105	58	18	49	5	71	128	57
Secondary education	49	27	16	43	1	14	66	29
Certificate	8	4	0	0	1	14	9	4
Diploma	5	3	1	3	0	0	6	3
Degree	10	6	1	3	0	0	11	5
Total	181	100	37	100	7	100	225	100

However, the table shows that a greater number of male entrepreneurs (13%) had acquired certificates, diplomas and university degrees, compared to only 6% of female entrepreneurs.

6.2 Education and Training²⁸ of Business Owners

Major findings

- Firms with owners educated above secondary school generated more profit than those with lesser education
- Firms with owners trained for more than one year generate more profit than those who attended training lasting for less than a year

Education is widely acknowledged as an important factor for entrepreneurship and business skills development. Table 11 shows that a majority of business owners that were educated above secondary level had completed further training lasting more than a year. Results also show that firms owned by entrepreneurs who had attended training courses lasting more than one year were generating higher profits than those firms with owners who had attended training of one year's duration or less.

²⁸ Training refers to tailor made and out of school courses provided to entrepreneurs. Such courses are provided by NGOs, Banks and other development institutions to provide entrepreneurs with special skills needed to run their businesses.

Table 11: Duration of Training Completed by Owners with Education above Secondary Level and Average Monthly Profits of Their Businesses

	Average Profits (TShs, monthly)	Number of Firms	% of Firms
Less than 1 year	235,000.0	20	31.7
1 year	122,812.5	17	27.0
More than 1 year	291,541.7	26	41.3
Total		63	100.0

6.3 Motivations for Starting Small Businesses

Major findings

- Most of the small businesses were motivated by push factors
- Firms motivated by pull factors had more potential to generate higher profits
- SSEs have greater potential to generate higher profits compared to MEs

Human beings have various demands on them and these shape their priorities and motivations for starting businesses. Reasons for starting a business can be classified into two types: push factors and pull factors. Push factors exist when a business entrepreneur is desperate or stranded to meet his/her basic needs. Such factors include loss of job, lack of employment, lack of adequate income sources, etc. On the other hand, pull factors are incentives that motivate business entrepreneurs to start businesses. Incentives include profits or additional income, diversification, growth, etc. It was hypothesised that the objectives for establishing a business have an influence on the operations of the business, and in turn, an influence on the profitability of the business.

Respondents were requested to indicate their motives in starting their current businesses. Table 12 shows that majority of the small business owners had been motivated by push factors (124 or 54.9%) compared to those motivated by pull factors (101 or 45.1%).

Table 12: Motivations of Owners for Establishing Their Businesses Compared with Monthly Average Profits (TShs)

	Average Profits	Number of Firms	%
Push factors¹	194,727.1	124	54.9
Pull factors²	391,064.2	101	45.1
Total		225	100

¹ Push factors include need of basic income and lack of alternative opportunities.

² Pull factors include diversification and profit generation.

This finding has significant ramifications on the potential for the small businesses to flourish. At the same time, strategic policy intervention to support firm-level expansion is further complicated as small businesses pulled by profit factors are much more responsive to their environment and to market

opportunities, compared to those who enter saturated markets due to the lack of better alternatives²⁹. As Parker *et al* (1995) indicated, supporting SMEs indiscriminately would not yield substantial growth of businesses, but ignoring them altogether may neglect potential high performers within their ranks. Table 12 shows firms that have been motivated by pull factors are generating more profit than those motivated by push factors.

6.4 Major Sources of Initial Capital

Major finding

Businesses which sourced capital from personal savings as well as profits from other businesses generated higher profits than businesses which accessed capital from other sources

A pre-requisite for starting a firm is to have financial capital as well as relevant business knowledge. The availability of financial capital is crucial for establishing and supporting any business. Usually, entrepreneurs will first draw on the funds that are cheapest to acquire, and will then proceed to more expensive funds if needed³⁰. Obviously, the perceived availability of capital to invest in a firm also determines what kind of opportunities entrepreneurs will consider.

Table 13 shows that most of the respondents sourced their initial capital from their own sources followed by those who obtained capital from their family members and relatives.

Table 13: Sources of Initial Capital

	Number of Firms	%
Personal savings	148	66
Family/friend loans	50	22
Profit from other businesses	23	10
Banks	2	1
Microfinance institutions	2	1
Total	225	100.0

The mode of initial capital acquisition has a bearing on the profitability of a small business. The mode of initial capital acquisition influences the degree of aggressiveness of entrepreneurs and might also indicate a certain degree of business skill. Almost all of the businesses surveyed (96.6%) sourced capital from personal or family savings, loans from friends, or profits from other businesses. Only 2% of firms accessed other sources of capital, i.e., banks and microfinance institutions.

Table 14 shows the findings on the different sources of initial capital compared against business profitability. The results show that a higher proportion of firms which sourced initial capital from informal sources such as family/friend loans experienced growing profitability, followed by those firms which used profit from other businesses as initial capital.

²⁹ One of the factors that stimulate the diversification of the small business landscape is the changing pattern of consumer spending/demand resulting from rising standards of living.

³⁰ OECD, 2004

Table 14: Sources of Initial Capital and Profitability Trend

Source of Initial Capital	More Profitability (number = 101)		Less Profitability (number = 80)		No Change (number = 44)		Total (number = 225)	
	No.	%	No.	%	No.	%	No	%
Personal savings	62	41	63	42	24	16	149	100
Family/friend loans	27	54	10	20	13	27	50	100
Banks	0	0	2	100	0	0	2	100
Profit from other businesses	10	47	6	26	6	26	22	100
Microfinance institutions	2	100	0	0	0	0	2	100

7. SOCIO-ECONOMIC FACTORS INFLUENCING EMPLOYMENT CREATION

In this section, the capacity of small business to create employment is assessed by examining two factors:

- 1) employment levels, focusing on socio-economic factors influencing firms to employ fewer people (1-5 employees) or more staff (6-10 employees); and
- 2) employment growth, focusing on whether firms had managed to increase the number of employees over time.

Earlier in this study the potential for employment growth within small businesses was found to correlate with firm size. This chapter looks at a number of issues that have been identified as growth determinants of firms (and thus determinants of employment growth). These include the characteristics of business owners such as their sex, level of education, activities undertaken before establishing their current business, motivations for starting businesses, sources of initial capital, and the types of technology used.

7.1 Gender of Business Owners

Major findings

- The ability to increase employment levels was influenced by gender
- A large proportion of the male-owned firms had increased employment levels compared to the proportion of female-owned firms

The results in section 6.1 indicated that the gender of business owners had an influence on the performance of small businesses in terms of profit generation. The remaining task was to establish if there was any link between employment creation and the sex of business owners. To do that, sex factors were cross-tabulated with employment levels and growth. Table 15 shows that 29% of female-owned firms had 6-10 employees which is slightly higher than male-owned firms (25%) with the same number of employees, implying that the potential for higher employment levels lies within female owned firms compared to male owned businesses.

Table 15: Employment Levels for Businesses by Gender of Owners

(number and percentage of businesses)

Type of Ownership	1-5 Employees		6-10 Employees		Total	
	No.	%	No.	%	No	%
Male owned	136	75	45	25	181	100
Female owned	26	71	11	29	37	100
Group owned	0	0	7	100	7	100
Overall	162	72	63	28	225	100

A majority of both male owned and female owned firms reported no employment growth (Table 16), but the proportion of the male owned firms that did not grow was slightly less (60%) than those owned by women (64%). In the growth category, the proportion of male owned firms (40%) was marginally higher than female owned firms (36%).

Table 16: Employment Growth by Gender of Owners

(number and percentage of businesses)

Type of Owners	No Growth or Declining		Growth		Total	
	No.	%	No.	%	No.	%
Male owned	109	60	72	40	181	100
Female owned	24	64	13	36	37	100
Group owned	0	0	7	100	7	100
Overall	133	59	92	41	225	100

7.2 Level of Education and Training

Major findings

- The majority of firms owned by entrepreneurs with higher than secondary education had increased their employment
- In general, participation in training programmes did not lead to firm growth; however, a longer duration of training contributed to employment growth
- Owners with better education ran businesses with higher employment levels

Depending on their level of education, individuals may differ in their ability to discover and exploit opportunities. People have access to different information, and process it differently depending on personal knowledge and preferences³¹. The ability to discover productive opportunities depends largely on previous education and work experiences. In view of this, the owners' level of education was cross-tabulated with the employment levels of businesses, and also with employment growth, to see if any relationships existed between these variables.

Table 17 presents the results of an analysis regarding employment levels and education. The majority of the entrepreneurs were educated to primary school level, a characteristic also observed in the studies by SwissContact (2004) and ESRF (1996). Table 17 further indicates that a majority of the respondents with businesses employing 1-5 staff possessed primary education (62%), while 53% of the respondents employing 6-10 employees had education of secondary level and above. These results highlight the fact that owners with better education tend to run businesses with higher employment levels.

³¹ Shane, 2000

Table 17: Comparison of Owners' Level of Education and Business Employment Levels

Education Level	1-5 Employees		6-10 Employees		All	
	Number	%	Number	%	Number	%
Primary education	101	62	27	43	128	57
Secondary education	41	25	25	40	66	29
Certificate	4	2	5	8	9	4
Diploma	5	3	1	2	6	3
Degree	9	6	2	3	11	5
None	2	1	3	5	5	2
Total	162	100	63	100	225	100

The influence of education on employment growth was also assessed. Table 18 demonstrates that a higher percentage of small businesses owners with education above secondary level (certificate, diploma and degree) had managed to increase their employment levels compared to firms owned by those with secondary school education and below.

Table 18: Comparison of Owners' Level of Education and Business Employment Growth

Education Level	No Growth		Growth		Decline		Total	
	No.	%	No.	%	No	%	No.	%
Primary education	74	57	48	38	6	5	128	100
Secondary education	36	55	26	39	4	6	66	100
Certificate	4	44	5	56	0	0	9	100
Diploma	2	33	4	67	0	0	6	100
Degree	4	36	7	64	0	0	11	100
None	2	40	2	40	1	20	5	100
Overall	122	54	92	40	11	6	225	100

These results are further supported by findings reported in Table 19. Almost two-thirds (65%) of owners of the 'growth' firms had attended training lasting more than one year, compared to 34% and 20% of owners of 'No Growth' and 'Declining' firms respectively. A surprising finding was that a substantial number of firm owners had received training, but still a large portion of these respondents reported no employment growth. This might be explained by the fact that most of the training provided for entrepreneurs is general in nature and not focused on the specific challenges experienced by small businesses.

Table 19: Comparison of Duration of Owners' Training and Business Employment Growth

Training Duration	No Growth		Growth		Decline		All	
	No.	%	No.	%	No.	%	No.	%
Less than 1 year	15	37	2	12	3	60	20	32
1 year or less	12	29	4	23	1	20	17	27
More than 1 year	14	34	11	65	1	20	26	41
Total	41	100	17	100	5	100	63	100

7.3 Activities of Owners Before Starting Their Business

Major findings

- Majority of firms with owners possessing prior business experience managed to increase their employment levels compared to other categories
- Being employed, unemployed or attending schooling prior to the current business did not contribute to the increase in employment levels

The involvement of owners in other enterprises prior to their current business provides a good proxy for the level of entrepreneurship among small business owners and can be used to further analyse employment trends of the surveyed firms. Two approaches were adopted. First, the proportion of entrepreneurs with prior business experience was determined. Table 20 shows that 41% of entrepreneurs were engaged in prior business activities representing a majority of SSE owners (55%), compared to a little over one-third of ME owners (36%). This indicates a strong level of entrepreneurship among SSE owners, which could have enhanced their risk taking, rent seeking behaviour, and search for new opportunities; factors that are important for business performance. Owners of MEs were marginally more likely to have been unemployed prior to their current businesses compared to SSE owners.

Table 20: Comparison of Prior Activities of Business Owners and Employment Levels

Prior Activities	1-5 Employees		6-10 Employees		All	
	No	%	No.	%	No.	%
Other business activities	58	36	35	55	92	41
Employed	50	31	17	27	68	30
Unemployed	15	10	4	7	20	9
Schooling	37	23	7	11	45	20
Total	162	100	63	100	225	100

Second, the influence of prior business activities on employment growth was investigated. It is interesting to note from Table 21 that in the category of those owners who had prior business experience, nearly one-half (47%) had managed to increase their employment levels compared

to other categories. Overall, the table indicates that most of the firms (54%) did not increase their employment levels, but this was more critical for entrepreneurs who were previously unemployed or schooling.

Table 21: Comparison of Prior Experience of Owners and Employment Growth

Prior Activities	No Growth		Growth		Decline		Total	
	No.	%	No.	%	No.	%	No.	%
Other business activities	43	46	44	47	6	6	93	100
Employed	33	49	30	45	4	6	67	100
Unemployed	14	69	5	26	1	5	20	100
Schooling	32	71	13	29	0	0	45	100
Overall	122	54	92	41	11	5	225	100

7.4 Owners' Motivations for Starting Business

Major findings

- Push factors were dominant among owners of firms employing 1-5 employees, while two-fifths of the firms with 6 – 10 employees were owned by those influenced by pull factors
- Majority of firms established out of pull factors managed to contribute to employment growth
- Majority of push factors firms either did not register employment growth or declined over time

The study investigated the influence of owners' motivations for establishing their businesses on firm employment levels. The results are recorded in Table 22. Push factors were the dominant motivations among owners of firms employing 1 – 5 employees (86%), while two-fifths (40%) of the owners of firms with 6 – 10 employees were influenced by pull factors.

Table 22: Comparison of Owners' Motivations for Establishing Business and Employment Levels

Motivations	1 to 5 Employees		6 to 10 Employees		All	
	Number	%	Number	%	Number	%
Pull factors	23	14	25	40	101	45
Push factors	139	86	38	60	124	55
Total	162	100	63	100	225	100

It was also of interest to know how motivations influenced employment growth within firms. Table 23 shows that a majority of the respondent enterprises (57%) motivated by pull factors had managed

to register employment growth over time. At the same time, 70% of the firms that indicated push factors had either registered stagnant or declining employment.

Table 23: Comparison of Owners’ Motivations for Establishing Business and Employment Growth (number and percentage of businesses)

Motivation	No Growth		Growth		Decline		Total	
	No.	%	No.	%	No.	%	No.	%
Pull factors	41	41	58	57	2	2	101	100
Push factors	81	65	34	27	9	5	124	100
Overall	122	54	92	41	11	5	225	100

Since additional income was one of the important pull factors, it may be argued that entrepreneurs seeking additional income were more aggressive in managing their business activities than those who aimed at getting employment only. Income motives require that the business makes a profit. For a person who engages in business as a way of securing employment, profit is not as a high priority as those with purely income motives.

7.5 Technology

Major finding

- A higher percentage of firms using electricity-based technology managed to register employment growth compared to the proportion of firms which registered growth using manual technology.

The influence of technology on employment growth was determined by comparing the types of technology used by businesses with their employment growth. The respondents were asked to indicate the type of technology they were using in their activities. Only 166 business owners responded to this question. Table 24 shows that a higher percentage of the small businesses (60%) using electricity-based technology had managed to register employment growth compared to the proportion of firms which registered growth using only manual technology (23%).

Table 24: Comparison of Business Technology and Employment Levels

Type of Technology Used	No Growth		Growth		Decline		Total	
	No.	%	No.	%	No.	%	No.	%
Manual	62	72	20	23	4	5	86	100
Electric	29	36	48	60	3	4	80	100
Overall	91	55	68	41	7	4	166	100

The influence of electricity-based technology is also noted in the table whereby almost three-quarters (72%) of firms which used manual technology did not grow.

7.6 Conclusion

Socio-economic factors found to have a positive influence on profit margins and employment creation included the owners' sex, level of education, and motivations for establishing their businesses, the sources of initial capital, and the technology used in the businesses. Therefore, we accept the hypothesis that socio-economic factors influence the contribution of small businesses to poverty alleviation. Results indicate that the profit levels generated by enterprises are influenced by these factors.

Furthermore, the results have shown that profits are likely to be higher if the entrepreneur is a male, is motivated by pull factors, is highly educated, uses modern technology, and has sourced initial capital from either personal savings or reinvested profits from other businesses.

8. LEVEL OF FORMALITY, PROFIT MARGINS AND EMPLOYMENT LEVELS

Business formality is an important aspect of entrepreneurship. Stiglitz & Weiss, (1981) and Harhoff *et al* (1998), indicate that theoretically, formal enterprises enjoy a greater incentive to take risk in business activities, thereby increasing the chances of higher profitability, as well as business growth compared with informal enterprises. This argument forms the basis for this section, which was intended to test the hypothesis that business formality influences the contribution of small businesses to poverty alleviation.

8.1 Attributes of Business Formality

Major findings

- Majority of the respondent firms had one or another attribute of formality
- The proportion of firms with none of the formality attributes was higher for MEs compared to SSEs
- MEs were less likely to be registered (12%) compared to SSEs (41%)

The study utilized three attributes of formality – business registration, licensing and tax payments^{32 33}, – to establish the impact of formality on profit margins and employment creation. Table 25 presents the number of business firms, which were registered, licensed and paid taxes. The results indicate that small businesses were at the margin between formal and informal sectors. While 31% of the respondent MEs had virtually none of the formality attributes, only 13% of the SSEs did not possess any of the attributes of formality. Furthermore, MEs were less likely to be registered (12%) compared to SSEs (41%).

Table 25: Attributes of Formality - Business Registration, Licence and Tax Payment

Attributes of Formality	Micro Enterprises (number = 162)		SS Enterprises (number = 63)		Total (number =225)	
	No.	%	No.	%	No.	%
Business registration	20	12	26	41	46	20
Business licence	83	51	49	78	132	59
Tax payments	66	41	49	78	115	51
None	51	31	8	13	59	26

³² Parker, *et al*, 1995

³³ Formality is defined in Parker, R.L *et al* (1995) as a concept indicating how well a firm is integrated into the modern economy. However, the concept of formality is not very clear as definitions vary significantly between studies. World Bank (2004) indicates that identifying firms under formal/informal classification is difficult as firms can be formal or informal to greater or lesser extent depending on their specific characteristics. Some of the registered firms are informal to some degree (e.g., some registered firms might evade taxation) and some of the unregistered firms are formal to some degree (e.g., have a bank account).

8.2 Business Registration, Profit Margins and Employment Creation

Major findings

- A majority of firms generated profits whether registered or not
- However, the percentage of registered enterprises generating profit was higher than the percentage of unregistered enterprises
- A majority of registered firms experienced employment growth
- A large percentage of unregistered firms had not grown or declined over time compared to registered firms

Table 26 shows the relationship between business registration and profit margins, demonstrating that most of the enterprises whether registered or not generated profit.

Table 26: Unregistered and Registered Businesses and Their Average Monthly Profits

	Average Profit (TShs)	Number of Firms	%
Unregistered businesses	257,766.7	179	70
Registered businesses	460,900.0	46	30
Total		255	100

Findings from Table 26 show that the average profit for registered enterprises was higher than the average profit for unregistered enterprises. This implies that the potential for enterprises to make higher profits lies with registered firms. It also implies that expanding the formalisation of the private sector has the potential to indirectly contribute to poverty alleviation – a drive which should go hand in hand with other policies that increase the incentives for small businesses to become more formal.

Furthermore, the owners of the businesses that were registered were requested to respond to questions related to registration process and cost of registration. Table 27 shows that majority of the registered enterprises were satisfied with the registration process (61%) and the cost incurred (61%).

Table 27: Registered Business Owners' Opinion on Registration Process & Cost

Registration Process	Micro Enterprises		Small Scale Enterprises		All	
	No.	%	No.	%	No.	%
Satisfied with the process	13	64	15	58	28	61
Bureaucratic	7	36	10	37	17	37
Corrupt	0	0	1	5	1	2
Total	20	100	26	100	46	100
Registration cost						
High costs	8	38	10	39	18	39
Affordable	12	62	16	61	28	61
Total	20	100	26	100	46	100

However the fact that majority of the firms were not registered, it implies some constraints in the registration process. World Bank (2004) points out that one limiting aspect, which is a disincentive for small businesses to register, is the absence of government programmes targeting small businesses, such as facilitating their market access through government procurements.

In terms of employment growth, Table 28 reveals that 52% of registered firms compared to 38% of unregistered firms had managed to expand employment. The other 62% of unregistered firms had not grown or had declined over time compared with 48% of registered firms. In other words, the contribution of informal firms to job creation was limited as compared to the contribution by formal firms. Registered businesses were able to secure advantages available to formal firms.

Table 28: Comparison of Business Registration and Employment Growth

	No Growth		Growth		Decline		Total	
	No.	%	No.	%	No.	%	No.	%
Unregistered businesses	100	56	68	38	11	6	179	100
Registered businesses	22	48	24	52	0	0	46	100
Overall	122	54	92	41	11	5	225	100

8.3 Business Licensing, Profit Margins and Employment Creation

Major findings

- Overall, small businesses generated profit whether licensed or not
- However, the percentage of licensed firms generating profit was higher than the percentage of unlicensed firms
- In terms of employment growth, a majority of licensed firms registered employment growth while a large percentage of unlicensed firms had not grown or had declined over time compared to licensed firms

Table 29 demonstrates that business licensing was not an advantage for business performance as most of the enterprises generated profit whether they were licensed or not. It also shows that licensed firms generated a slightly higher average profits compared to unlicensed firms. This implies that the potential for enterprises to make higher profits lies more with licensed firms compared to unlicensed firms. By comparing results on registration and licensing, the aggregate level of profits (Tshs. 278,252) for licensed enterprises is less than for those in the registration category (Tshs. 460,900). This implies that the strength of the registration to influence profitability is lower than that of licensing.

Table 29: Unlicensed and Licensed Businesses and Their Average Profits

	Average Profit (TShs)	Number of Firms	%
Unlicensed businesses	272,715.1	93	41
Licensed businesses	278,252.0	132	59
Total		225	100

Further investigation as recorded in table 30 shows that 50% of the respondents had a positive opinion on licensing costs³⁴, while 27% of the respondents were neutral regarding licensing costs. Only 24% of the respondents had negative attitudes towards licensing costs.

Table 30: Owners' Attitudes Towards Licensing Costs

Attitude	Micro Enterprises		Small Scale Enterprises		All	
	No.	%	No.	%	No.	%
Positive	83	51	29	46	112	50
Negative	32	20	21	33	53	24
Neutral	47	29	13	21	60	27
Total	162	100	63	100	225	100

Table 31 presents the results on the relationship between business licensing and employment growth. The table indicates that 55% of licensed enterprises managed to register employment growth at the same time the percentage of unlicensed firms with 'no growth' employment is higher than the percentage of licensed firms under the same category.

Table 31: Licensed and Unlicensed Businesses and Employment Growth

	No Growth		Growth		Decline		Total	
	No.	%	No.	%	No.	%	No	%
Unlicensed businesses	67	72	20	22	6	6	93	100
Licensed businesses	55	42	72	55	5	4	132	100
Overall	122	54	92	41	11	5	225	100

³⁴ This might be attributed to the initiative by the Minister of Finance to abolish business license fee for SMEs with turnovers below TShs 20 million per annum. However these results should be read with care. On average most of these enterprises have been in operation for about 5 years, in the sense that their positive opinion on licensing costs might simply be an expression of optimism on the part of the respondent.

8.4 Tax Payments, Profit Margins and Employment Creation

Major findings

- Most of the enterprises generated profit whether they paid tax or not
- The percentage of tax-paying enterprises generating profit was marginally higher than the percentage of those which did not pay taxes

Table 32 shows the relationship between enterprises paying taxes and profit margins. The table demonstrates that tax payment was not an important factor on profit levels.

Table 32: Businesses that Paid and Did Not Pay Tax and Their Profits

	Average Profit (TShs)	Number of Firms	%
Businesses not paying taxes	279,761.9	110	49
Businesses paying taxes	284,038.1	115	51
Total		225	100

As for the registration and licensing categories, similar results were found when taxation was linked to employment growth (Table 33). For example, 59% of the tax paying enterprises visited managed to grow compared to 22% of the not paying taxes firms. The percentage of tax paying firms with growing employment was higher than the percentage for 'not paying firms' suggesting that tax paying as an attribute of formality had a remarkable influence on employment growth. Table 33 also shows that the percentage of tax paying firms with declining employment was slightly higher than the percentage of not paying firms, though this is considered negligible on the basis of the number of cases.

Table 33: Comparison of Business's Tax Paying Status and Employment Growth

	No Growth		Growth		Decline		Total	
	No.	%	No.	%	No.	%	No.	%
Businesses not paying taxes	81	74	24	22	5	5	110	100
Businesses paying taxes	41	36	68	59	6	5	115	100
Overall	122	54	92	41	11	5	225	100

Several studies such as CTI (2000) and World Bank (2004) found that the business environment in Tanzania is characterised by high tax rates and cumbersome administration procedures. To further look at how effective tax reduction as a policy option was, the findings demonstrated in Table 34 indicate that although 70% of the respondents were negative on tax rates only 30% of those were also negative on the concept of taxation. This suggests that majority (70%) of the respondents were in favour of the taxation concept implying that a policy to reduce tax rates might be productive in reducing tax evasion, thereby further strengthening the formalisation of small business entities.

Table 34: Perceptions of Respondents on Tax Rates and Tax Concept

Attributes	Those Positive Or Neutral on Tax Rates		Those Negative on Tax Rates		All	
	No.	%	No.	%	No.	%
Those positive or neutral on tax concept	103	84	71	70	174	77
Those negative on tax concept	20	16	31	30	51	23
Total	123	100	102	100	225	100

8.5 Conclusion

The major intention of the analysis conducted in chapter 8 was to test the hypothesis that business formality influences the contribution of small businesses on poverty alleviation. It is clear from the findings that majority of the interviewed firms generated profit, whether they possessed formality attributes or not.

However, further analysis shows that the potential to generate higher profit lies mostly with formal firms compared to informal enterprises. The results on the comparative analysis and cross tabulations of formality variables with profit and employment confirmed that formal business have more prospects than informal ones. However, the findings indicate that although formality might have an influence on profit generation and employment growth, it was not capable by itself to enable small businesses to increase their performance.

9. EMERGING POLICY CONCLUSIONS

Are the findings of the current study consistent with the analytical underpinnings of the existing SME policy? In the course of implementing economic reforms as well as structural adjustment to make the private sector the engine of growth, the Tanzanian government introduced a SMEs development policy in 2003 aimed at addressing constraints facing SMEs. The SME policy also contained different strategies that the government intended to pursue to benefit the SMEs sector. However, does the policy and identified strategies take into account analytical work both on poverty and the small business landscape? In this section, some of the findings of this research study are compared with the conceptual underpinnings of the SME policy. In addition, the usefulness of the policy will be assessed, both in terms of its intended objective as well as its implementation framework.

Job creation and income generation are the specific objectives of the SME policy. However, the rationale for the SME policy also embodied the concept of poverty alleviation:

*"..... in Tanzania, the SME sector has been recognised as a significant sector in employment creation, income generation and poverty alleviation ..."*³⁵

This statement illustrates that poverty alleviation was clearly an objective of the SME policy. It raises the question of the role of SME in poverty alleviation. Is the creation of survivalist enterprises an effective poverty alleviation strategy? This study shows that majority of small businesses earned little. One of the main characteristics of these businesses was their priority to survive. Hallberg, K (2001) indicates that the reason that developing countries should be interested in small businesses is because they account for a large share of firms and employment, in other words, because "they are there." Searching for further justification to promote small business as an instrument of poverty alleviation is necessary and productive.

Which modes of interventions are appropriate and are relevant at the policy level? Another deficiency of the SME policy is its preference for 'supply side interventions', such as providing access to training and credit to existing and new businesses.

Another of the explicit objectives of the SME policy is to encourage the establishment of new SMEs and to improve the performance and competitiveness of existing ones. However, we should note that, the creation of the MEs is highly contentious especially if sustainability is a paramount objective. Given the characteristics of the market in which MEs operate, i.e., low income, low value-added activities, fierce competition and over-trading, a deliberate strategy to replicate these kinds of businesses simply threatens existing businesses and results in insecurity for existing entrepreneurs³⁶. This study shows that business performance in terms of profit generation and employment creation is positively related to the size of the firm, suggesting that strategies that promote vertical growth are more favourable than those promoting horizontal growth.

It is also apparent that the SMEs policy has, at the same time, devised a policy framework and strategies that outline the intention of the government for the SMEs' sector. However, the strategies to address constraints facing the SMEs' sector fail to differentiate between the different sectors within small business. Small businesses are heterogeneous in nature, and they have specific strengths and weaknesses that may require special policy responses, e.g. improving access to markets for MEs demands very different strategies to that of improving access to markets for small enterprises. There is a need to strengthen the formative research for policy making so that policy makers can make decisions in an informed manner based on empirical evidence.

³⁵ URT (2002)

³⁶ Broembsen, 2003

10. SUGGESTED FURTHER RESEARCH

This research examined the extent to which small businesses have a role in poverty alleviation, and concludes that small business policy needs careful consideration. However, this study is not exhaustive on the role that small businesses play in job creation and economic growth.

It is believed that both the rates of gross job creations and gross job losses are significantly higher for small firms than their larger counterparts, reflecting greater turbulence/turnover of staff among small firms. Therefore, future research work could investigate net job creation to better determine the employment capacity of small businesses. **Currently**, there is also no reliable and current data on the small business sector. Most of the recent surveys³⁷ were limited in coverage and compilation of critical data that would facilitate further analysis on the role of small businesses from both socio-economic and macro-economic perspectives. In this case, there is a need for a baseline survey that will provide accurate, formative data on the characteristics and performance of the small business sector.

³⁷ SwissContact 2003

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| Brief 8 | Mawazo ya AZISE za Tanzania Kuhusu Uhusiano Wao na Wafadhili | TGN1 | What is the Tanzania Governance Noticeboard? |
| Brief 7 | Mawazo ya AZISE za Tanzania Kuhusu Uhusiano Wao na Serikali | LGR 12 | Trust in Public Finance: Citizens' Views on Taxation by Local Authorities in Tanzania |
| Brief 6 | Local Government Reform in Tanzania 2002 - 2005: Summary of Research Findings on Governance, Finance and Service Delivery | LGR 11 | Domestic Water Supply: The Need for a Big Push |
| Brief 5 | Children Participating in Research | LGR10 | Is the community health fund better than user fees for financing public health care? |
| Brief 4 | Changes in Household Non-Income Welfare Indicators - Can poverty mapping be used to predict a change in per capita consumption over time? | | |

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| LGR 9 | Are fees the major barrier to accessing public health care? | LGR 4 | TASAF – a support or an obstacle to local government reform |
| LGR 8 | Primary education since the introduction of the Primary Education Development Plan | LGR 3 | Councillors and community leaders – partnership or conflict of interest? Lessons from the Sustainable Mwanza Project |
| LGR 7 | Citizens' access to information on local government finances | LGR 2 | New challenges for local government revenue enhancement |
| LGR 6 | Low awareness amongst citizens of local government reforms | LGR 1 | About the Local Government Reform project |
| LGR 5 | Fees at the dispensary level: Is universal access being compromised? | | |