SOURCES OF FINANCE AVAILABLE TO SMALL SCALE ENTERPRISES IN NAIROBI, KENYA

BY

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DECLARATION

This project is my original work and has not been presented in any other university or for any other award.

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DEDICATION

Dedicated to my Father Edward Nalwelisie, my Mother Roselyne Nabwile, Sister Chikombe, Nabiliki, my Brothers Carey Mukolongolo Casper Sudi and Mukanda, for your encouragement and support during the course of my study.
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ABSTRACT
The role of SSEs as a source for employment is highly significant. Since SSEs operate on a labour-intensive basis, they are able to create employment. Estimates indicate that micro-enterprises provide work for 20-40% of total labour force.

In the literature, it is widely recognised that small-scale enterprises (SSEs) play a vital role in poverty reduction and employment creation in developing countries. One of the major development constraints faced by SSEs is their lack of access to adequate credit. The main research question of this study is therefore: How can the access of SSEs to credit be improved?

In Kenya, there is a gap between the credit supply of both informal and formal providers of credit to SSEs, which use both sources of credit, depending on the specific conditions and purposes of credit. The Kenyan financial system is marked by a dualistic structure, i.e. the financial sector is characterised by the existence side by side of formal and informal financial markets. In developing countries such as Kenya this financial dualism arises because the formal financial sector is underdeveloped, a fact, which is also, reflected in an inadequate formal credit supply for SSEs, in particular by, banks. The informal suppliers of credit make up in part for this lack of financial services. However, the financial services provided by informal suppliers are also inadequate.

Two approaches are suitable to narrow the gap. On the one hand, formal actors could adopt the strengths of informal actors, to the extent that this is possible for them: This is the so-called downscaling approach. Informal financial actors have certain strengths, which formal actors could learn from in order to improve their credit supply for SSEs. On the other hand, informal actors could, as far as possible, be integrated into the formal system: The is the so-called modified upgrading approach.

The overall objective of this study was to explore alternative sources of finance in the development of Small-Scale Enterprises in Nairobi, Kenya.

Small firms have long been a matter of concern for government and policy makers. In the populist tradition of thought, an economy based on small firms has been regarded as the alternative to the standard course of capitalist industrialization, generated, with its tendency towards increasing concentration of industries in the hands of a few large firms. Also covered in this section are; determinants of capital structure, uncertainty and information asymmetry, sources of loanable funds, institutional theories of disequilibria credit rationing, macro and micro-based theories, apprenticeship training and a few other concepts.

Methodology is discussed in chapter three where the method of data collection, sample size, selection and data analysis procedures are explained.

Chapter four covers the findings, data and descriptive statistics.

Finally in chapter five are the conclusions of the findings, recommendations strategies and limitations of the study.
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CHAPTER ONE

1.0 Introduction

In the period after independence, many African countries attempted to leap directly to a modern industrial structure through public investment in large-scale industries (Steel and Webster 1992). The state often took the lead for lack of a strong indigenous entrepreneurial class and to avoid dependence on foreign investors. But inadequate attention to economic viability and market prospects resulted in substantial excess capacity, with many large firms unable to survive without heavy protection or subsidies. Many enterprises were squeezed, first by economic crises and, subsequently by adjustment policies that reduced protection, cut back subsidies, restrained demand and changed relative prices. Given budgetary restraints and a policy shift away from direct ownership of productive enterprises, governments have had to look increasingly to the private sector to take the lead in future industrialization. The important role played by small-scale enterprises in developing economies has been increasingly realized over the past years. Not only are they important for the vitality of the business sector, they also provide new jobs. But in order to play their role in future, there is need for researchers and policy makers to identify this role and constantly interact to bring about a sustainable policy framework. For industrial development methods to have maximum effectiveness, they must include methods specifically adapted for work with small industries. It has long been known that technique suited to promoting large-scale industries is not the best in promoting modernization and growth in small industry and vice versa (Stanley and Morse, 1965). It is in the light of this that those functional differences that justify separate analysis of the role of small industry in development and growth must be outlined, and what is seen as a constraint be analysed. Most of the small-scale enterprises adapted apprenticeship training to boost entrepreneurial managerial skills for most of its managers. However, since there was no deliberate policy to stifle the growth of small businesses, it implied that the subsequent governments realized their potential. Stanley and Morse (1965) identified three types of policies towards SSEs development namely, passive, protective and developmental. A passive policy is one of neglect, resulting from indifference, lack of information, or lack of
leadership. A protective policy is designed to defend existing small enterprises against competition from large and modern enterprises. The developmental approach to small scale enterprise promotion has as its objective the creation of economically viable enterprises which on their own feet without perpetual subsidy can make a positive contribution to the growth of real income, and therefore to better living standards. Kenya’s policies on SSEs though not explicitly stated, seem to gear towards the developmental approach. Policy instruments that can be used to achieve developmental policy objectives included the following,

- The provision of industrial advisory services
- The training of entrepreneurial managers and supervisory personnel
- Provision of developmental finance

Apprenticeship has been described as a form of skill acquisition in the context of production or on the job training (Valenchick, 1995). Apprentices gain up-to-date quality training and learn to work efficiently.

The role of apprenticeship training has been viewed as a critical element for the development of Small Scale Enterprises (SSEs). Small-scale enterprises have been classified according to the degree of informality and the size of employment. Formal and small such enterprises conform to regulations to a significant extent, exhibit high levels of human capital and are integrated into the structures of the formal economy. Informal and small enterprises are those that are successful, emergent or entrepreneurial. It is in these enterprises that informal sector incomes can outstrip those in the lower reaches of the formal sector. (Mead, 1998). The owner operators of such enterprises have significant exposure to both formal education and training and to formal employment. In the Survivalist perspective, they view the small-scale enterprise in terms of the equation between poverty and informal sector where it is most apparent as they are not only engaged primarily in commerce but also in basic and low quality forms of production and those running these enterprises are typically at the level of subsistence, with the income earned being one of a number of sources that must be combined together in order for survival (Mead, 1998).
Most of the studies on small scale enterprises (SSEs) in Kenya in particular, and Africa in general, have noted the significance of apprenticeship training in the background of individual entrepreneurs as part of the working force, as well as a premise for the creation and provision of training (Mabawonku 1978). Although apprenticeship is a very important factor in the development of SSEs in Kenya, many of the studies done on SSEs have always considered the aspect of apprenticeship training as incidental to the main focus, hence very little attention has been directed towards this area per se. (Ekpenyong and Nyong, 1992; Olaniyan, 1998). SSE are reputed are reputed to be behind most of the socio-economic transformation in South East Asia, and play significant role in Kenya’s development process. This is because during the early stages of economic development, these enterprises embodied unique opportunities for creating employment and wealth.

While a lot has been written on the growth of formal education systems in Africa, with due reference to evaluating the role of education on productivity earnings, inequality and economic growth (See Collier and Lall, 1986; Hazlewood and others, 1989; and Knight and Sabot, 1990), quite a few information is available and known on apprenticeship training in generating human capital for the SSEs. Recognising the importance of apprenticeship training should be the first step towards understanding the nature of skill formation, increased workforce, productivity and growth in the SSEs.

The need for working capital is readily identified to be a major constraint by entrepreneurs, according to numerous surveys, but these are often construed rightly or wrongly by researchers to be a mere smokescreen for other more pressing problems such as lack of managerial training and market saturation.

It is worth noting that small enterprises do raise their start-up capital (which mainly goes towards fixed assets such as tools and machinery) primarily, if not solely, from personal sources (Table 1). The same can be said of their working capital needs in roughly the first 3-4
years of operation (Liedholm 1990, 1991). In Papua New Guinea, this is also true as confirmed by a recent survey of 461 enterprises who ranked personal savings as the primary source of capital, followed by family members and relatives; and finally loans from commercial and institutional sources (Darkoh, et al. 1996). That this is the case should come as no surprise since micro enterprises need to build up their assets and reputation prior to any borrowing from either formal or informal credit sources.
Table 1. Summary of evolving small enterprises and the supply and demand for finance by stages

<table>
<thead>
<tr>
<th>Status</th>
<th>Supply/Demand for Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>After experience/training, entrepreneur commences operation</td>
<td>Inception stage</td>
</tr>
<tr>
<td>1st 3-4 years of struggle with high probability of failure and little growth. Limited assets and reputation with meagre external sources of finance</td>
<td>Operational Stage</td>
</tr>
<tr>
<td>Surviving firms are likely to experience a sudden “spurt of growth” that will typically project them into the large size category of small firms.</td>
<td>Post-operational Stage</td>
</tr>
<tr>
<td>Micro enterprises now graduate into modern small or medium enterprises</td>
<td>Graduation Stage</td>
</tr>
</tbody>
</table>

Inception stage
Average of 95% of working capital met entirely by family (parents) or close friends/relatives while less than 1% comes from moneylenders. Fixed capital need is modest.

Operational Stage
Working capital need predominantly met by internal cash flow, families and friends/relatives, plus reinvestment of profits.

Post-operational Stage
External sources of finance begin to emerge commensurate with reputation, assets, product quality and delivery performance.

Customer credit, trade credit and moneylenders meet working capital. The latter grows as a source relative to its size in the inception stage, but use of it is infrequent due to high interest rates not infrequently 100%.

Fixed capital need also grows for which 2 informal sources are available: supplier credit and sub-contracting. Overall, need for term finance increases for its fixed capital needs which only formal credit sources can effectively meet.

Graduation Stage
Need for both fixed and working capital expands greatly, also access to formal financial market increases and the cost of credit may fall as firms’ age.
However, if this source remains inconvenient and slow, firms will be forced to utilise informal credit sources. And given the often meagre profits of many small firms, use of moneylenders will continue to be a last resort, i.e. only after personal sources have been exhausted.

In the period after the first 3-4 years, however, their need for credit becomes increasingly pronounced (Table 1). This need is more acute for working capital than for fixed capital among small enterprises relative to their medium and large counterparts. The result is that accessible information on credit sources needs to be made available to assist firms to obtain the requisite credit for their growth.

1.1 Statement Of The Problem
Previous studies have highlighted the limited access to financial resources available to SSEs compared to larger organisations and the consequences for their growth and development (Levy, 1993). Typically, smaller enterprises face higher transactions costs than larger enterprises in obtaining credit (Saito and Villanueva, 1981). Insufficient funding has been made available to finance working capital (Peel and Wilson, 1996). Poor management and accounting practices have hampered the ability of smaller enterprises to raise finance. Information asymmetries associated with lending to small-scale borrowers have restricted the flow of finance to smaller enterprises. In spite of these claims, some studies show a large number of small enterprises fail because of non-financial reasons (Liedholm, MacPherson and Chuta, 1994).

There are numerous problems that hinder the growth of small-scale enterprises (SSEs) in Kenya. Among them are, lack of access to credit, competition from the large-scale industries, the over liberalization of the economy, and difficulty in access to advisory services and research findings (Boapeah, 1993). The cardinal issue of lack of credit to small-scale enterprise development is particularly prominent in developing countries, and pertaining mostly to credit from formal financial institutions. Many small firms for reasons such as too difficult processes and fear that they will be refused if even applied refuse to apply for formal loans. It is therefore not uncommon to see most of the SSEs resorting to “traditional” sources of finance such as company-retained earnings, personal savings, borrowing from friends and relatives, supplier credit, borrowing from moneylenders, and other sources including revolving fund and inheritance.
SSEs tend to have poor collateral base and therefore get excluded from the credit markets. Even when their asset base is rich, property rights problems, reduce the collateral value of such assets. Where enterprises can successfully seek out credit from formal sources, they may not bother to borrow because of limited ability to comprehend debt management and costs of borrowing, fear related to potential hidden costs, previously disastrous experiences with financial services, presence of surrogates such as savings and credit associations, and cultural norms that discourage borrowing. They may lack enough cash to meet the application costs. The expected loan receipts are functions of actual amounts expected to be raised and the enterprise estimations on the probability that the loan application will be successful.

Despite the existence of a number of prolific literatures from studies carried out on SSEs, they have ignored the aspect of apprenticeship training as a form of raising working capital for SSEs. SSEs are generally undercapitalised, suggesting major operational difficulties in accessing credit and pursuing corporate goals. The recent SSEs Baseline Survey showed that only six percent of SSEs successfully applied for and used credit. It is unclear how the rest who form the majority meet their working capital and investment needs. By introducing the payments of fees, where the trainees are supposed to pay fees, these fees paid can be used as a source of finance to ease constraints on working capital.

Thus this project aims at establishing the sources of finance available to SSEs including apprenticeship training.

1.2 Objectives Of The Study

The overall objective of this study was to explore alternative sources of finance in the development of Small-Scale Enterprises in Nairobi, Kenya.

Specifically this study intended:

1. To identify which types of credit are easily obtainable to SSEs
2. To evaluate the credit policies of SSEs
3. To establish the contribution of apprenticeship training as a source of finance
4. To make relevant policy recommendations to enhance the financing of SSEs

1.3 Research Questions

1. Do the credit policies include support services that make any meaningful impact on the growth and development of SSEs, such as training of entrepreneurs and provision of technical and advisory service etc?
2. Can any meaningful inferences be made on internal and external capital relations?
3. What are the sources of working capital finance available to SSEs in Nairobi, Kenya?
4. What are the policy recommendations that can be made to SSEs to increase their accessibility to credit facility in Nairobi, Kenya?

1.4 Scope Of The Study

Spatially, the study was limited to the operations of SSEs in Nairobi Gikomba region. The location was chosen due to data availability and also because it was acknowledged that most entrepreneurial activities are concentrated in this region. The credit lines that the research focused on were classified into,

- Formal credit (Bank loans)
- Overdraft.
- Government Financing, (Credit Schemes)
- Informal credit sources such as;
  1) Credit unions.
  2) Borrowing from friends and relatives,
  3) Supplier credit,
  4) Borrowing from moneylenders.
  6) Apprenticeship fees

The study covered the following areas of the entrepreneurship of the Kenyan economy,

Wood products     Furniture works
Metal works        Machinery works
1.5 Justification Of The Study

Successful industrialization must have an indigenous base, and expansion of the small-scale manufacturing sector would help develop entrepreneurial and managerial skills as a basis for efficient indigenous investment in and management of larger industries (Kilby, 1988). Because SSEs tend to be labour-intensive and to use low levels of technology, a strategy to expand the SSE sector is likely to be consistent with employment and income distribution objectives, while allowing for sustained productivity increases through improvements in technology (Stanley and Morse, 1965). Also SSEs can respond flexibly under difficult and changing conditions because they do not depend heavily on infrastructure, and because their typically low levels of technology allow product lines and inputs to be changed at relatively low cost (Steel, 1977). Even when large-scale industries dominate, many SSEs retain competitive advantage by serving dispersed local markets, providing differentiated products with low-scale economies for niche markets, or specializing as sub-contractors for larger firms (Anderson, 1982). Small-scale enterprises are fairly distributed across the length and breadth of Kenya, and their potentials in economic activities involving employment, sales, and export, forms an interesting area to be studied. Policies such as financial and technical assistance to help in their growth and development are thus worth studying. The evaluation of the public sector financial assistance scheme would serve as a guide to private and non-governmental organizations that have established or are to establish similar facilities for the SSEs. In summary therefore, if SSEs are important to employment generation, income distribution and all those prospects we have seen, then how they are capitalized and the difficulties they may experience in financing, are important policy issues.

Moreover, evaluating the credit-related policies for SSEs would go a long way to helping their development and growth. Finally, a modest contribution would also be made towards the general literature of small-scale enterprises in Kenya.

The findings of this study will have contribution to the following functionaries:
1 Government: To develop policies that encourages development of SSEs.
2. Ministry of Education Science and Technology: To develop a good training curriculum to encourage apprenticeship training.

3. Credit markets: To determine how much to advance to small-scale enterprise by being able to project their repayment schedule with certainty.

4. Researchers: To identify areas that need further research to improve the credit appraisal techniques.
2.0 Literature Review

2.1 Theory Of The Small Firm

Small firms have long been a matter of concern for government and policy makers. In the populist tradition of thought, an economy based on small firms has been regarded as the alternative to the standard course of capitalist industrialization, generated, with its tendency towards increasing concentration of industries in the hands of a few large firms (Kitching, 1982). Size theories of the firm can be classified into four approaches, namely, conventional microeconomic approach (or the technological approach), the transaction cost approach (or the institutional approach), industrial organization approach, and the dynamic model of size distribution approach (You, 1995).

In the conventional microeconomic approach, firm size is determined by technical and allocation efficiency. The traditional analysis of firm size is conducted in the context of a competitive equilibrium. In a competitive equilibrium, the actual firm size will be the efficiency size in the sense that the long-run average cost is minimized at that point. Here, the technologically determined economies of scale and scope are the principal determinants of firm size (You, 1995). The efficient firm size can be determined uniquely only if the long run average cost curve is U-shaped. One way by which decreasing returns to organization size may occur is where there is a fixed input such as the entrepreneurial input. Kihlstrom and LaFont (1979) see the propensity to take risk in the face of uncertainty as the central quality of entrepreneurship. Firm size therefore, depends on the individual entrepreneur’s willingness to take risk. Marx (1976) posits that changes of efficient firm size over time depend on the nature of technological change. Lucas (1978) posits that there is a given distribution of managerial talents across entrepreneurs.

In equilibrium therefore, the greater the talent of an entrepreneur, the greater the size of the firm (measured in number of employees) he manages. Those with talents below that of marginal manager, who is indifferent between being a manager and being an employee, will
automatically be employees. According to Lucas, in this way a full size distribution of firms can be determined from a distribution of talent (skills). The model rationalizes the common observation that the number of small firms increases during recession. Since in this model the wage rate represent opportunity cost of becoming a manager, the falling real wages and the rising unemployment in recession will induce some ‘marginal’ employees who were previously wage-earners to switch to setting up their own business. In the transaction cost theory, firm size is determined by transaction cost efficiency. Here the efficient size of the firm is determined where the marginal intra-firm transaction cost (cost of internalising one more transaction) equals the market transaction cost (Coase, 1937). While market transaction costs explain why firms exist, intra-firm governance costs explain why the efficient firm size is limited. The third approach is the industrial organization approach. Firm size and its distribution (market structure) are determined by market power. In this approach there is no presumption that the observed firm size or its distribution is efficient or in the process of adjustments towards the efficient equilibrium. Rather, the size distribution of firm is thought to reflect the distribution of market power and the competitive structure of the market. The market share of firms in an industry with heterogeneous products will depend not only on the pricing strategy but also on which segment of the market they serve. The size of a firm serving different segments of the market may differ for at least two reasons. One is that they may require different technologies. Another reason is that the magnitude of demand (the location of the demand curve) may differ across different segments of the market. In this vein, firms producing mass-consumption goods will be larger than firm producing specialty goods (You, 1995).

The fourth theory is the dynamic model of the size and distribution of a firm’s approach. This includes stochastic models, life-cycle models and evolutionary models. The stochastic model for instance, is based on the Gibral’s law, which states that the growth rate of a firm is independent of its current size and its growth

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1 This is only a special case of prediction of the model, namely a positive correlation between
the level of income and the average size of the firm, which is the hypothesis Lucas (1978) tests in his paper with the US data. In fact it is hard to believe that such a model that equates a firm with a manager can be applied to large corporations. This model seems to make more sense when it is applied only to small firms history (You, 1995). If every firm experiences the same growth rate subject to random variations year after year, the size distribution will turn to a log normal distribution. That is a skewed distribution rather closed to the typical size distribution of firms actually observed in most industries. It is also important to acknowledge the qualitative factors that distinguish a small business from a large firm. In the United States, the Committee for Economic Development has out-lined four characteristics that describe the domain of a small business (Hodgetts and Kuranthko 1998).

The factors are:
Management of a small business is independent, since the manager usually owns the firm.
Capital is usually supplied by an individual or a few individuals hold ownership.
The area of operations is primarily local, although the market is not necessarily local.
The firm is small in comparison with the largest competitors in the industry. Taken together, these characteristics provide a qualitative description of small business.

2.2 Theoretical Framework On Finance
A decision to start a business or expand an already existing firm by increasing the productive assets, involves an implicit decision to raise money capital in order to finance the growth. There are three main sources of funds; namely equity financing (issues of shares), debt financing (issues of bond), and the use of retained earnings. The first two sources, equity financing and debt financing constitute external financing, while retained-earnings are an internal source of finance (Koutsoyiannis, 1982). The financing decisions involve the determination of the optimal mix of the various sources of funds required for financing the assets of the firm. Given the different sources of funds, the financing decisions imply two separate types of decisions. First, management must decide the optimal capital structure of the firm, that is, the optimal proportion of debt in its total capital. The capital structure is
reflected in the firm's debt-equity ratio, (that is the proportion of debt to equity in the total assets of the firm). Second, management must decide an optimal dividend payout ratio (the ratio of dividends to total earnings available to shareholders after payment of interest and corporate taxes) that implies the determination of the retention ratio, the proportion of earnings to be retained for financing investment projects that will yield increased earnings in future periods (Koutsoyiannis, 1982). The financing decisions therefore involve the determination of an optimal debt equity ratio (capital structure decision) and optimal dividend-payout decision (retention-dividend policy).

The optimality of a decision is related to the goal of the firm (in other words, a decision is considered as optimal if it contributes to the attainment of the goal of the firm). In the traditional theory of finance the goal of the firm is assumed to be the maximization of the market value of the firm to its shareholders.

There are three main theories, on the goal of stockholder-wealth maximization, that deserve consideration. All three examine the question as to whether there is a capital structure that maximizes the value of the firm by minimizing the average cost of its capital (Koutsoyiannis, 1982). The first theory, known as the classical or traditional theory postulates that there is a unique optimal capital structure which maximizes the market value of the firm by minimizing the average cost of its capital. A version of this theory, developed by Solomon (1963), postulates that there is a range of optimal capital structures, over which the discount rate (average cost of capital) attains its minimum value, resulting in the maximization of the market value of the firm.

The second theory was developed by Modigliani and Miller (1958) under the assumptions of perfect capital markets and no corporate taxes. This theory postulates that the value of the firm and consequently the wealth position of stockholders are not affected by the capital structure (type of financing) (Koutsoyiannis, 1982) The third theory, also developed by Modigliani and Miller (1958), takes into account corporate taxes and postulates that a firm should use as much debt as
possible to maximize its value.

2.3 Determinants Of Capital Structure

A list of factors that are thought to affect the financing decisions of firms are as discussed below.

2.3.1 The goal of the firm

We mentioned that if the goal of the managers is the maximization of stockholders wealth, the optimal capital structure is the one that maximizes the market value of the firm to its original stockholders. If the goal of the managers is on the other hand the maximization of their job security, the optimal capital structure is the “typical” average leverage of other similar firms in the industry (Koutsoyiannis, 1982).

2.3.2 Availability of internal funds: the rate of growth of earnings

There is ample evidence that managers have a preference for internal funds over external sources of capital. The main determinant of internal funds is the growth in earnings of the firm. A high earnings growth rate enables management to have more funds from retained earnings, so that less external finance will be required. Thus one might expect a negative relationship between the rate of growth of earnings and the debt-equity (D/S) ratio. The rate of growth in earnings may affect the D/S ratio indirectly in two ways (Koutsoyannis, 1982): Firstly, a high rate of growth, if financed with debt, will increase the earnings per share by more than if it were financed by common stock, due to the tax-deductibility of interest payment (tax shield) (Copeland and Weston, 1992). The effect of the growth of earnings on the debt/equity ratio in this event would be positive. This effect, however, may well be expected to be absorbed by the corporate tax rate which itself is another determinant. Secondly, a high earnings growth rate will almost certainly boost the price of the common stock, making equity financing more attractive than debt financing. This effect of growth in earnings on the D/S ratio should be absorbed by the stock price, which is also a separate determinant of capital structure.
2.3.3 Availability of internal funds: the retention policy of managers

The amount of internal funds does not depend only on the growth of total earnings but also on proportion of earnings retained (retention ratio). This in turn depends on the growth potential of the firm and the ability of managers to persuade shareholders that the available investment opportunities are profitable. The retention ratio is expected to be negatively related to the debt/equity ratio, since a high proportion of retained earnings reduce the need for debt financing.

2.3.4 Credit limit (or debt capacity of the firm)

The attempt of managers to adjust their actual D/S ratio to their desired level is constrained by the attitudes of creditors. It is generally accepted that lenders in the capital market ultimately define the debt capacity of firms, that is the level of safe (risk free) borrowing, or the amount of debt which firms can undertake without serious danger of financial failure (Koustoyiannis, 1982). Creditors' beliefs about the debt capacity of a firm are thus based on such variables as the size of the firm, its potential growth, and its business risk.

The size of the firm:

It is observed that large firms can borrow funds more easily and on better terms than small firms (ibid). This may be attributed to creditors' beliefs that larger firms are less likely to become insolvent. In this event, “size” is expected to be positively related to the debt/equity ratio. (However, although the size of assets enlarges the debt capacity of firms, large firms may not be willing to avail themselves of the larger availability of loanable funds, preferring to rely on retained earnings).

The growth potential:

The growth of assets may be considered as a fairly satisfactory indicator of the future development opportunities of the firm. Furthermore, the growth of assets reflects the total needs for funds of the firm. On both accounts one should expect a positive relation between
the growth of assets and the debt/equity ratio, ceteris paribus.

**Business risk:**

Usually measured by the variability of earnings. Creditors are inclined to provide capital to firms whose earnings are stable since earnings uncertainty increases the risk of bankruptcy (Copeland, and Weston, 1992). For job-security reasons managers are also affected in their decision to use debt by the stability of earnings of the firm. Stable earnings allow a more liberal use of debt, because the firm can regularly meet the fixed costs of debt. In either case the variability of earnings is expected to be negatively related to the debt/equity ratio.

Credit markets differ from the goods markets in that the goods markets, which are the focus of classical competitive theory, involve a number of agents who are buying and selling a homogeneous commodity where payment for the commodity occurs simultaneously (Jaffee and Stiglitz, 1990). In contrast, credit (in money or goods) received today by an individual or firm is exchanged for a promise of repayment (in money or goods) in the future.

Accordingly a credit market is sometimes assumed to have the following features:

1) A multiplicity of freely operating financial intermediaries constituting the credit supply side, while homogenous deficit-spending investors make up the demand side;

2) Both intermediation and investment activities are driven by profit maximization motive;

3) Intermediaries mobilize financial resources through the issue of primary securities to surplus spending units or savers;

4) Resources mobilized are allocated among investors through the issue of secondary debt securities;

5) Both types of securities are designed in such a manner that they suit the investment and financing needs of both the savers and investors respectively with regards to maturity, risk-return preferences, liquidity and marketability etc;

6) Since transactions are competitive, agents do not posses undue market power which they can use to manipulate the quantity of credit or interest rates to their advantage;

7) The assumption of perfect market symmetry and completeness of information holds
as intermediaries and borrowers possess similar and all the required information on the quality of the investment projects.

8) And intermediation transaction cost is negligible (Mwenda, 1993).

All things being equal, given the above assumptions and other things held constant, credit supply increases monotonically while demand decreases with interest rates. If credit markets were like standard markets then interest rates would be the “prices” that equate demand and supply for credit. However, excess demand for credit is common, applications for credit are frequently not satisfied. As a result the demand for credit may exceed the supply at the market interest rate (Jaffe, 1990).

Credit markets deviate from the standard model because the interest rate indicates only what the individual promises to repay, not what he will actually repay (which means that the interest rate is not the only dimension of a credit contract).

The issue of the allocation of credit has profound implications at both the macro and micro levels. At the micro level, in the absence of a credit market, those with resources would have to invest the resources themselves, probably receiving a lower return than could be obtained by others. When credit is allocated poorly, poor investment projects are undertaken, and the nation’s resources are squandered. The special nature of credit markets is most evident in the case of credit rationing, where borrowers are denied credit even though they are willing to pay the market interest rate (or more), while apparently similar borrowers do obtain credit (ibid).

2.4 Uncertainty And Information Asymmetry

Differences between promised and actual repayments on loans are the result of uncertainty concerning the borrower’s ability (or willingness) to make the repayments when they are due. This creates the risk of borrower default (Jaffee and Stiglitz, 1990). The sources of uncertainty can be analysed by distinguishing between two types of risks, namely business risk and financial risk.

Business risk arises from the uncertainty of the realization of the expected earnings of the
firm. This uncertainty arises from possible changes in prices of the products and of the factors of production, changes in consumers’ tastes, changes in the methods of production, and the reactions (decisions) of competitors. In other words, business risk arises from general business conditions in the economy (general economic and political conditions).

Financial risk arises from the use of debt for financing the firm’s operations. As indebtedness increases, the fixed costs of servicing the debt rise. Since debt holders (creditors) have a priority claim on earnings, the existence of debt increases the uncertainty of the flow of net earnings available to the entrepreneur (after interest payments). Furthermore, the use of debt exposes the entrepreneur to a potential loss of his total equity, if total gross earnings fall below the fixed charges of debt that is if the firm becomes insolvent (which may lead to legal bankruptcy).

Given that borrowers and lenders may have differential access to information concerning a project’s risk, they may form different appraisals of risk; we refer to symmetric information as the case in which borrowers and lenders have equal access to all available information. The opposite case asymmetrical information is where the borrower knows the expected return and risk of his project, whereas the lender typically knows only the expected return and risk of the average project in the economy (Jaffee and Stiglitz, 1990).

The amount of information about an enterprise is generally not neutral with respect to size. Peterson and Rajan (1992) observe that small enterprises are most likely to face credit rationing because most potential lenders have little information on the managerial capabilities or investment opportunities of such firms and are unlikely to be able to screen out poor credit risks, or to have control over borrowers’ investment. This information gap problem on credit supply is buttressed by Jaff and Russel (1976) when they indicated that if lenders were unable to identify the quality of risk associated with particular borrower, then credit rationing would occur. This phenomenon is analogous to the lemons argument advanced by Akerlof, (1970).

The existence of asymmetric information prevents the suppliers of funds from taking the right investment decision. In their analysis of Business Angels, Harrison and Mason, (1994) pointed out that there are business owners, whose firms are constrained in their growth by a “shortage” of equity, and who would be prepared to share their equity with the informal
investors. The implication of their research is that an information barrier exists between the two groups and that it would be beneficial to the economy as a whole if this barrier were overcome. In other words there is the problem of asymmetric information in the equity market as far as small business operations are concerned and this leads to market failure that calls for government intervention.

2.5 The Sources Of Loanable Funds
Lenders obviously need funds to make loans, so the cost and availability of loanable funds necessarily interacts with loan market activities. Mostly “banks” is used as descriptive shorthand of lenders and “deposits” used for sources of loanable funds.

In his lemons market argument, Akerlof illustrated the possibility of non-existence of equilibrium in hidden information problems due to adverse selection funds (Jaffee and Stiglitz, 1990). However, the following points indicate how the analysis generally applies to all types of lenders.

Bank lending is typical of most lending. Although the bank loan is the dominant form of credit in many countries, capital market instruments, such as bonds, are also used for credit transactions. Capital markets and loan markets share similar problems, and solve many of them in comparable ways, as the following examples illustrate:

The underwriting process for new risky bonds is intensive in gathering information concerning the borrower’s credit worthiness, and likelihood of default is reflected in the rate of return required by investors.

Credit ratings are used to classify risk levels (although the screening and lending functions tend to be separated more in capital market transactions than in lending transactions).

Restrictive covenant in corporate bond contacts are comparable to non-price terms in loan contracts, both reflecting attempts by lenders to control the extent of default risk.

Bank deposits can be treated as safe securities. For simplicity, deposits are treated as the source of loanable funds-as though they were free of default risk. This is actually the case with respect to bank deposits insured by federal deposit insurance.

Even without such insurance, depositors generally receive the fixed return promised by a
bank because banks hold diversified portfolios of loans and their capital and loan loss reserves provide a further tier of protection (Jaffee and Stiglitz, 1990).

2.6 Borrower Classification Theory Of Credit Rationing

Jaffee and Modigliani (1969) developed a borrower classification theory of equilibrium or long-run credit rationing (Mwenda, 1993). In this model a lender uses objective criteria such as industrial classification, firm size, standard financial characteristics such as dividend policy or profitability etc. to classify borrowers into groups. Risk adjusted and profit-maximizing lending rates are then determined for each borrower in a given group. Next, an optimal rate to be applied uniformly to borrowers in each group is determined. This rate is determined so that it falls between the smallest and largest individual rates. Then in each group, borrowers whose credit demand exceeds supply at the uniform rate are rationed. A lender prefers rationing to increasing interest rates to clear loan applications, as the latter (increasing interest rates) would violate the borrower classification scheme.

2.7 Institutional Theories Of Disequilibria Credit Rationing

The institutional or financial repression theories of disequilibria credit rationing are of two types. These are comprised of original macro-based theory attributed to both Mckinnon (1973) and Shaw (1973), and a micro-based theory developed by Tybout (1983).

2.8 Macro-Based Theory

Mckinnon (1973) and Shaw (1973) proposed different mechanisms by which financial markets function. In Mckinnon’s view, financial markets operate according to the complementary hypothesis, whilst Shaw’s mechanism is based on the debt-intermediation hypothesis. For the analysis of credit rationing, we examine the context of the debt-intermediation hypothesis.

The debt-intermediation hypothesis states that perfect and freely functioning financial markets operate according to the Walrasian market (Mwenda, 1993).

Accordingly whilst demand for loanable funds is inversely related to interest rates, financial
savings are highly responsive to interest rates. Equilibrium is characterized by market
clearance as flexible interest rates equalize the demand and supply of credit. The hypothesis
further states that financial repression, generally defined as administrative setting of interest
rates below their market clearance levels, distorts credit markets. Thus at any rate below the
equilibrium interest rate, financial savings and hence credit supply are discouraged but
demand for credit is boosted. The ensuing demand deficit compels intermediaries
(banks/lenders) to ration credit on non-interest criteria such as customer reputation, political
connections, size and quality of collateral and related attributes.

2.9 Micro-Based Theory

Micro-based theory of financial repression was developed by Tybout (1983) to improve upon
the original macro model by characterizing the nature of credit allocation bias at the firm
level. According to Tybout, the absence of financial repression, intermediaries offering
unique sets of loan contracts to individual borrowers characterize credit market equilibrium.
The contracts are unique in the sense that they reflect the peculiarities of the credit worthiness
attributes of each borrower in terms of risk, profitability, initial indebtedness etc.
Furthermore, the debt contract term for each borrower is set such that the bank maximizes
expected profits on loan.

Tybout then hypothesizes that financial repression makes loan contracts of certain borrower
categories unprofitable from the intermediaries' viewpoint. He specifically proposes that loan
contracts of small-scale borrowers are rendered unprofitable by financial repression. This is
because repression lowers lending rates below those required to maximize expected profits on
loans to these categories of borrowers. Thus in the absence of repression, intermediaries
would charge small-scale borrowers higher interest rates to maximize expected profits, since
these borrowers are assumed to have the poorest credit worthiness. Consequently, in order to
avoid incurring losses, intermediaries prefer to ration small-scale borrowers from their loan
portfolios under repression.
2.10 Firm Size And Liquidity Constraint

Whilst recently generated evidence points to the importance of financial structure and liquidity constraint to the investment decision, their source and severity remain an open question (Chirinko, 1993). In reviewing the role of financial constraints on investment behaviour, Chirinko (1993, pp. 1094) states, “the investment literature has been schizophrenic concerning the role of financial structure and liquidity constraints”. Empirical models of business investment rely generally on the assumption of a “representative firm” that responded to prices set in centralized security markets.

Indeed, if all firms have equal access to capital markets, firms’ responses to changes in the cost of capital or tax-based in investment incentives will differ only because of differences in investment demand (Fazzari, Hubbard and Peterson, 1988). That is the financial structure of a firm that does not play an important role in investment decisions, since the firm can costless substitute external funds for internal capital. Under the assumption of perfect capital markets, then, firm-specific investment decisions are generally independent of the financial condition of that firm.

The assumption of the perfect capital market has of course been challenged rigorously. And once it is no longer assumed that capital markets are perfect, it also can no longer be assumed that external capital is a costless substitute for internal capital (Audretsch and Elston, 1995). An implication of this view is that the availability of internal finance access to new debt or equity finance, and other financial factors may shape firms’ investment decisions. Modigliani and Miller’s (MM) representative firm models in which financial structure is irrelevant to investment decision may well apply to mature firms with well-known prospects.

For other firms like the young and smaller firms however, financial factors appear to matter in the sense that external capital is not a perfect substitute for internal funds, particularly in the short-run. (Fazzari, Hubbard and Peterson, 1988).
Stiglitz and Weiss (1981) argue that liquidity constraints become more severe as firm size decreases. They pointed out that unlike in most markets, the market for credit is exceptional in that the “price of the good”, the rate of interest, is not necessarily at a level that equilibrates the market. They attribute this to the fact that interest rates influence not only the demand for capital, but also the risk inherent in the different borrowers.

As the rate of interest rises, so does the riskiness of borrowers. This leads to adverse selection, as we expect only the “high-risk-high-return” business to participate in the market at these high interest rate levels. This in turn may lead suppliers of capital to rationally decide to limit the quantity of loans they make at any particular interest rate.

A large body of literature has pointed to the prevalence of apprenticeship training as an important feature of SSEs in African countries, particularly in East Africa. In a series of studies from 1961 to 1964, Callaway (1964) called attention to the widespread nature of indigenous apprenticeship training in Kenya. He reported that over 71% of the proprietors in the SSEs, received their training through the apprenticeship system. Evidence from Kenya by Steel and Webster (1992), stated that 44% Kenyan micro-enterprises who entered business after 1984 had been apprentices.

The findings of Velenchik (1995), also on Kenya, indicated that 72% of the small enterprises sampled trained apprentices, while former apprentices own 66% of enterprises. Also Liedholm and Chuta (1976) found that apprentices comprised 42% of the labor of small firms in Sierra-Leone. Spectral analysis by Velenchik (1995) shows that apprenticeship training in Kenya was more prominent in woodworking and furniture and the metal working sectors relative to the textiles and garments and the food sectors accordingly. A party hosted by the graduated apprentice has observed apprenticeship training system in West, and East Africa to be characterized by the payment of fees, the provision of living allowances, and the marking of the end of training. (See; King, 1977; Berry, 1985; Bas, 1989; and Coy, 1989.)
2.11 Apprenticeship Training

Apprenticeship has been described as a form of skill acquisition in the context of production, or on the job training (Velenchik, 1995). Both King (1977) and Berry (1985) noted that apprenticeship in trade is a route to self-employment. According to Mabawonku (1978), the decision to seek apprenticeship training depends on the ability of the parents or sponsors of a youth to finance the cost of additional formal education. For poor parents, to whom the cost of secondary education is beyond reach, apprenticeship training is one of the alternatives for acquiring marketable skills for their children. He further observed that the occupations of nearly all the parent of the apprentices are low income ones. Thus, such low-income parents are often unable to pay the high costs of higher education, and hence, send their children to seek their fortune in the apprenticeship system that is cheaper.

However in the final analysis, the decision to seek training is functionally related to the “price” of apprenticeship and the rate of returns to training in different enterprises. Mabawonku (1978) remarked that while data are available to parents on the rates of return to alternative skills, their perception of the labor market often depends on the demand for and the supply of skilled labor in their locality, and the relative success of people who have learned similar skills in the area.

From the point of view of the suppliers of training, what is involved include, whether training being offered is general or enterprise specific. In general training, skills acquired can be marketed outside the particular enterprise or trade responsible for training. While specific training deals with skills that are particular to the enterprise (Becker, 1971 a and b).

General training increases a worker’s productivity once he moves to another enterprise. Hence, enterprise or enterprises will provide general training when the returns from training in the form of fees equal the costs of training. In specific training, the cost of training will be borne by the firm undertaking the training since the skills acquired cannot be used outside the
The agreement signifying apprenticeship-training contracts often covers issues like the length of time for training, the amount and the mode of payment of fees and performance of the "freedom ceremony". Signatories to the agreement include the master, sponsor and a witness. Agreements are not prepared in courts of law, or in the presence of lawyers, as is the case in most European countries, but in an informal setting. Disputes over the fulfilment of obligations are settled among the parties concerned without recourse to legal or judicial authorities. Nevertheless, certain literature note that if the source of a dispute has to do with the sponsor of an apprentice refusal to pay the fee in full, then the master can deny performing the "freedom" ceremony, in which case no certificates or evidence of training would be given to the apprentice.

However, Velenchik (1995) noted that firms offering specific training or employers financing general training would offer training profiles designed to discourage quits. Unlike the organized labor markets, apprenticeship training is not characterized with definite hours of works. Later, he is considered as a part and parcel of such establishments and he is expected to perform activities that are even unrelated to his training schedule. Indeed, the apprenticeship system is seen by both parties contracting the training as being more than just training a youth in marketable skills. It is viewed as part of a large process of bringing up the youth, which are in part delegated to the master. This implies that the pattern of training, even when blood relationships do not exist between an apprentice and his master, follows the same pattern as when a father is teaching his children some special skills (Mabawonku, 1978).

The organizational orientation of training in the apprenticeship system is basically informal. The entire training is carried out on the job. There is a hierarchy of authority in each SSEs, the master who is supreme delegates authority to the oldest apprentice or journeyman, who in turn delegates part of the authority to the next senior and so on down the line. The length of
training depends on the age of the apprentice, his level of education and the particular enterprise or trade of interest. Ekpenyong and Nyong (1992) reported that the average length of training ranges from three years to six years in the auto-repairs and furniture craft. In addition, these researchers reported that over 70% of the apprentices sampled are in their teens with about 80% having completed at least primary school education. More importantly they observed that, compared with their masters (proprietors), apprentices appear to be better educated in all enterprises studied (auto-repairs, furniture craft, and tailoring). On intergenerational mobility in apprenticeship training, Callaway (1964) reported that less than 10% of his respondents were engaged in similar trade as their parents. But Mabawonku (1978) observed a 50% intergenerational mobility in agriculture in Kenya.

Credit, whether in cash or in kind, has been reported to have played a crucial role in investment decisions of individuals and business enterprises (Ekpenyong and Nyong, 1992). However Bhatt (1989) notes that credit markets are inherently imperfect in the sense that there is no certainty about the completion of a credit transaction. A credit transaction involves a relationship between a lender and a borrower in time (hence in the context of uncertainty). A credit transaction is completed only when the borrower repays the amount borrowed and there can be no certainty about this repayment. This, therefore, makes eligibility requirements very high. These eligibility requirements such a collateral or guarantees usually prevent poor individuals and the SSE’s from having access to institutional credit.

However, significant changes in the design and provision of institutional credits have taken place to enhance credit availability to the needy poor and SSE’s during the last two decades. A plethora of distinct types of financial/credit organisations have emerged including cooperatives, multi-purpose development agencies with credit responsibilities (finance houses), and NGO-based financial credit programmes.

Paradoxically, most of the changes made in institutional design have been largely of
superficial window dressing type, rather than substantial. The evidence is in the large number of institutional failures in Kenya, however failure is defined (IFAD, 1987). Consequently, poor individuals SSE’s have had to rely on informal sources e.g. moneylenders, and other small investment fund organisations. For the SSE’s in particular, and developing countries in general, the institution of apprenticeship training and the payments of apprenticeship fees constitute an important source of investible income, though there are variations in fees between enterprises in the same industry and between different industries as have been observed in Kenya and Sierra Leone by Callaway, (1968) and Liedholm and Chuta, (1976).

A survey of small industries in Kenya by the I. L. O. team (ILO, 1970) found that apprenticeship fees were a source of capital and income for proprietors in the area of study. Berry (1985) contended that apprenticeship fees apart from being a useful source of working capital do alleviate constraints on working capital and increases enterprises profits, since apprentices do not receive wages. Velenchik (1995) noted that businesses meet their working capital needs through some combination of their own liquidity and formal sources of credit, such as banks and input suppliers. Firms with weak cash flow and lacking access to banks and supplier credits will use informal sources of finance, such as borrowing from moneylenders, or holding funds with informal savings collectors or mobile bankers in order to have access to funds at the end of the month, or requiring advance payments from customers. Thus Velenchik (1995) perceives the use of informal finance as a spill over from formal financing markets, in which agents who are rationed out of formal sources turn to informal markets.

Furthermore, Velenchik (1995) observed that firms with good cash or access to formal finance at reasonable costs would be expected to be able to finance their apprentices training and would be less likely to charge fees. These firms would also face lower costs for working capital and could share this advantage with workers by not charging fees. Her opinion rested on the conviction that the charging fees to apprentices, which is similar to the practice of
requiring advance payment from customers, is itself a form of informal finance because the fees are often generally paid before the training is received. Therefore firms charging apprentices’ fees would also probably use other informal source of credits. Velenchik (1995) study confirms the hypothesis that firms without strong cash flows or access to credit from the formal sector are more likely to charge fees. Overall, the results indicate that a relation exists between credit market behavior and the use of apprenticeship fees and those firms with more access to credit markets are indeed less likely to charge fees.
3.0 Methodology

3.1 Research Design
The researcher used descriptive research to assist him in attaining data to test hypothesis or to answer questions concerning the current status of the subject in the study. The purpose of descriptive research was to determine and report the way issues were. It described such issues as possible behaviour, attitudes, values, and characteristics.

3.2 Population and Sample of the Study
The population was drawn from the entrepreneurs and the trainees engaged in apprenticeship. Sectors to be covered included: woodwork, textiles, metalwork, and mechanics. This population was drawn from Gikomba area. An attempt was made to cover all available apprentices in the region.

The sample size was approximately 90 entrepreneurs.

3.3 Sampling Strategy
The researcher used random sampling technique to allow equal opportunity for all. All small-scale enterprises including those engaged in apprenticeship were considered.

3.4 Data Collection Procedure
The study employed both primary and secondary data. Primary data was derived through the administration of questionnaires. This however was used in conjunction with secondary data, which borders on government policies and institutional finance as well as credit markets reforms in Kenya. Questions included both open-ended and closed-ended. The questionnaires were distributed to the respondents and others were self-administered. Secondary data was also used to gather information that was not be attained by the questionnaire.
3.5 Data Analysis

Data was analysed using statistical package for social sciences (SPSS). There were tabulations, mean, percentages, variances and correlation to establish the linkages. Econometric models and statistical analysis was used for the analysis and synthesis of the research data.
CHAPTER FOUR

4.0 Data and Descriptive Statistics

This chapter reports the data collected from the questionnaires. This section also involves analysis on the entire sample thus all size categories inclusive.

4.1 Evidence Of Credit Constraint

An analysis of enterprises that closed down indicates that more than one third of such enterprises closed for lack of working capital. This is therefore the most important reason for business closure as shown in table 1.

Table 1: Reasons for Business Closure

<table>
<thead>
<tr>
<th>Reason</th>
<th>Response rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shortage of working capital</td>
<td>36.2</td>
</tr>
<tr>
<td>Personal reasons</td>
<td>20.0</td>
</tr>
<tr>
<td>Too few customers</td>
<td>14.3</td>
</tr>
<tr>
<td>Started another business</td>
<td>13.3</td>
</tr>
<tr>
<td>Other reasons</td>
<td>9.5</td>
</tr>
<tr>
<td>Too many competitors</td>
<td>6.7</td>
</tr>
<tr>
<td>Relevant sample size (n)</td>
<td>90</td>
</tr>
</tbody>
</table>

Source: Author’s survey

Some of our entrepreneurs interviewed had only one source of credit, but the majority reported having relations to three or four different sources of credit. Second, many SSEs had relations to formal and informal financial sources at the same time. Third, some SSEs had no financial relations at all.

As Table 2 illustrates, 21 had approached one or more moneylenders, 17 had taken out one or more bank loans, 16 were participating in a ROSCA, 15 raised from Family and friends, apprenticeship fees was used by 5, while NGOs were approached by 16 entrepreneurs.
Table 2: Credit Sources of SSEs in the Sample

<table>
<thead>
<tr>
<th>Sources of Credit</th>
<th>Number of SSEs Approaching this Source of Credit</th>
<th>Number of Loans Obtained from this Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moneylender</td>
<td>21</td>
<td>31</td>
</tr>
<tr>
<td>Bank</td>
<td>17</td>
<td>27</td>
</tr>
<tr>
<td>ROSCAS</td>
<td>16</td>
<td>22</td>
</tr>
<tr>
<td>Family and Friends</td>
<td>15</td>
<td>18</td>
</tr>
<tr>
<td>Apprenticeship Fees</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>NGOs</td>
<td>16</td>
<td>27</td>
</tr>
<tr>
<td>Total</td>
<td>90</td>
<td>127</td>
</tr>
</tbody>
</table>

An analysis of sources of initial capital and additional capital yields information on the extent to which SSE’s have access to adequate credit. Data shows that the most important sources of capital for both initial and additional capital are own funds and family resources (table 3). Given the very low incomes and savings rate, these findings suggest that SSE’s fall back on these sources for lack of alternatives and out of desperation. Alternative credit sources are either costly or out of reach for the majority of these enterprises. They are therefore hard up with regard to access to credit.

Table 3: Sources of Initial and Additional Capital

<table>
<thead>
<tr>
<th>Source</th>
<th>Initial Capital</th>
<th>Additional Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own or family funds</td>
<td>88.6</td>
<td>80.4</td>
</tr>
<tr>
<td>Loans from family or friends</td>
<td>7.0</td>
<td>6.2</td>
</tr>
<tr>
<td>Commercial bank</td>
<td>0.7</td>
<td>1.8</td>
</tr>
<tr>
<td>Formal and informal co-operatives</td>
<td>1.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Non-bank finance institutions</td>
<td>0.7</td>
<td>1.1</td>
</tr>
<tr>
<td>Rotating saving and credit schemes</td>
<td>0.7</td>
<td>1.1</td>
</tr>
<tr>
<td>Other (NGOs Government programmes, trade credit, money lenders and others)</td>
<td>1.1</td>
<td>8.1</td>
</tr>
<tr>
<td>Relevant sample size (n)</td>
<td>90</td>
<td>90</td>
</tr>
</tbody>
</table>

Source: Author
4.2 SSE’s Inclined to borrow

There are transactions costs related to borrowing, such as those related to preparation of application and waiting time. Even when enterprises feel a need for external credit, they may not borrow if their perceptions on the costs of applying for a loan far outweigh the expected receipts. They may also lack enough cash to meet the application costs. The expected loan receipts are functions of actual amounts expected to be received and the enterprise estimates on the probability that the loan application will be successful. Some enterprises may therefore choose to build internal funds through retained earnings as a means of for investment rather than rely on external sourcing.

Other circumstances may force enterprises not to borrow. In addition to high application costs, investment profitability that is too low to match interest rates on loans may reduce demand for external borrowing (Bigsten et al, 2000). Enterprises may also shy away from borrowing due to a poor collateral position. The collateral position is affected by assets, outstanding debt and opportunities for collateral substitutes such as legal status, ethnicity, networks, firm age, ownership structure and links with financial institutions. Transaction costs and collateral requirements imply that there would be enterprises that prefer external funds but are unable to apply for them. Such firms are the same category as those who apply for but do not receive loans. They are therefore credit constrained.

Research findings show that about 90% of SSEs perceive borrowing as necessary for business. Only a small percent do not like credit. Furthermore, most of them would to save their businesses from collapsing if and when that became necessary. Only a small proportion would rather allow their businesses to collapse than borrow. Similarly, the majority of the enterprises perceive the impact of borrowing on business performance as generally positive (table 4). Evidently, entrepreneurs’ attitudes towards borrowing as well as perceptions about the importance of business credit are progressive. These attitudes are, by implication, not an impediment to participation in the credit markets.
Table 4: SSEs entrepreneurs' attitudes towards borrowing

<table>
<thead>
<tr>
<th>Measures of attitude</th>
<th>Levels of response (%) (n=90)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Opinions about borrowing</strong></td>
<td></td>
</tr>
<tr>
<td>Necessary for business</td>
<td>90.6</td>
</tr>
<tr>
<td>Do not mind it</td>
<td>7.0</td>
</tr>
<tr>
<td>Do not like it</td>
<td>2.3</td>
</tr>
<tr>
<td><strong>B. Preference if unable to continue without borrowing</strong></td>
<td></td>
</tr>
<tr>
<td>Borrow to sustain business</td>
<td>88.3</td>
</tr>
<tr>
<td>Close the business</td>
<td>7.8</td>
</tr>
<tr>
<td>Sell the business</td>
<td>3.9</td>
</tr>
<tr>
<td><strong>c. Impact of borrowing on business</strong></td>
<td></td>
</tr>
<tr>
<td>Generally positive</td>
<td>96.9</td>
</tr>
<tr>
<td>Generally negative</td>
<td>3.1</td>
</tr>
<tr>
<td>Indifferent</td>
<td>0</td>
</tr>
</tbody>
</table>

Results for the self-selection process that maps out the inclination to seek out credit are presented in table 5, which shows that enterprises owned by males are more likely to seek out credit than those owned by females, as do formal enterprises (those that are registered) relative to the unregistered ones. The gender results are however, not statistically significant, therefore conclusions drawn from them are not firm. The impact of formality is however statistically significant, so that the researcher can firmly conclude that formal enterprises are systematically less inclined to apply for a loan, relative to informal enterprises. Informality represents unclear property rights and a poor collateral base. For these reasons, informal enterprises are more likely to self-select from credit market.
Table 5: Logistic Estimates of the Odds for Applying for a Loan

<table>
<thead>
<tr>
<th>Variables</th>
<th>Estimated Coefficients</th>
<th>Standard Errors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male-owned</td>
<td>-0.091</td>
<td>0.218</td>
</tr>
<tr>
<td>Registered/formal</td>
<td>0.4871*</td>
<td>0.277</td>
</tr>
<tr>
<td>Age of enterprise</td>
<td>0.019</td>
<td>0.014</td>
</tr>
<tr>
<td>Age of proprietor</td>
<td>0.027*</td>
<td>0.010</td>
</tr>
<tr>
<td>Size of enterprise</td>
<td>0.018</td>
<td>0.028</td>
</tr>
<tr>
<td>Sole proprietorship</td>
<td>-0.193</td>
<td>0.221</td>
</tr>
<tr>
<td>Proprietor’s education level</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary</td>
<td>0.508</td>
<td>0.459</td>
</tr>
<tr>
<td>Secondary</td>
<td>0.921</td>
<td>0.465</td>
</tr>
<tr>
<td>Post secondary</td>
<td>1.265</td>
<td>0.592</td>
</tr>
<tr>
<td>Constant</td>
<td>-4.521</td>
<td>0.640</td>
</tr>
<tr>
<td>Log Likelihood Ratio</td>
<td>772.195</td>
<td></td>
</tr>
<tr>
<td>Goodness to fit</td>
<td>1733.183</td>
<td></td>
</tr>
<tr>
<td>Cox and Snell</td>
<td>0.018</td>
<td></td>
</tr>
<tr>
<td>Naglekerke</td>
<td>0.051</td>
<td></td>
</tr>
</tbody>
</table>

Note: An asterisk denotes statistical significance at least at the 5% level.

The results also indicate positive association between the ages of both the enterprises and owners and the inclination to seek out credit. The older the enterprise and entrepreneur, the more likely that the latter will seek out a business loan. Longevity implies more experience useful in self-selecting in the credit market. The results are statistically significant so that there is confidence about odds. Considering the rather short life expectancy of SSEs, there could be a demand side problem related to the enterprise mortality rate. Some of the enterprises do not probably live long enough to build contacts and reputation needed in seeking out and making use of credit.¹

The size of an enterprise has a positive impact on the likelihood for seeking/applying for a loan. In other words, even within the size range that defines SSEs, those that are relatively larger are more inclined to apply for a loan than those that are smaller. The smaller the

¹ The mean enterprise age is 4.23 years. Formal enterprises and those that are male owned are significantly older.
enterprise, the less the likelihood that it would apply for a loan. Considering the size structure of the SSE sector, size itself is a major impediment to effective participation by enterprises in the credit markets. The results are however not statistically significant.

The estimation elicited a negative coefficient for enterprises that are under sole proprietorship. By implication, enterprises that have the sole proprietorship type of ownership are less inclined to seek out credit relative to enterprise under other ownership structures. Sole proprietorships are therefore less prone to risk taking.

Education has a definite positive impact on the likelihood to seek out credit. The strength of this impact increases monotonically with educational attainment, so that more educated entrepreneurs are more inclined to seek out external funds.

In conclusion, the inclination toward seeking funds is the product of a mixture of enterprise and entrepreneur attributes. Specifically, older, more educated entrepreneurs operating older, larger, and/or formal/registered enterprises are more likely to seek out external credit. In other words, interventions that promote enterprise longevity and mainstream informal enterprises would increase the likelihood for such enterprises to seek out credit. Since the participation in the credit market is largely a self-selection process, outcomes of such participation can be more enterprise supportive through interventions that the life expectancy of enterprises. Since informality is a response to the regulatory environment, formalization, which would improve the property rights situations faced by most SSEs would benefit from reductions in registration and licensing costs. Increasing the educational attainment of the pool from which SSE entrepreneurs derive would also increase the inclination to seek out credit.

4.3 Incident of Trade Credit

Many entrepreneurs (66.9%) have developed long term relationships with their suppliers (table 6). These relationships are important for reducing information asymmetries between entrepreneurs and their suppliers of goods, and in paving the way for trade credit as evidenced by consignment sales, pre-payments and supplier credit. More than 75% of the entrepreneurs perceive good reputation as either very important or at least important for trade credit. 46% of the entrepreneurs perceive supplier credit as common. However, 39% of the

---

2 Although trade credit may drive the need for strong business relationships, the benefits from such relationships are broader. There is also a type-of-goods factor in trade credit, that entrepreneurs dealing in raw materials and more durable general provisions are inclined to engage in trade credit.
enterprises receive credit from their suppliers only sometimes, mostly only when needed. However, a small proportion often receives such credit and a slightly larger proportion sometimes only.

**Table 6: Evidence of Trade Credit**

<table>
<thead>
<tr>
<th>Description</th>
<th>Response level (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses with long term relationships with suppliers</td>
<td>66.9</td>
</tr>
<tr>
<td>Businesses receiving credit from their suppliers</td>
<td>39.4</td>
</tr>
</tbody>
</table>

**Frequency of supplier credit:**

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Response level (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Often</td>
<td>8.3</td>
</tr>
<tr>
<td>Sometimes only</td>
<td>22.9</td>
</tr>
<tr>
<td>Rarely</td>
<td>10.4</td>
</tr>
<tr>
<td>Only when needed</td>
<td>58.3</td>
</tr>
<tr>
<td>Businesses extending supplier credit to others</td>
<td>62.7</td>
</tr>
</tbody>
</table>

**Reasons for extending supplier credit:**

<table>
<thead>
<tr>
<th>Reason</th>
<th>Response level (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Problems with repayment</td>
<td>44.0</td>
</tr>
<tr>
<td>Poor capital base</td>
<td>20.0</td>
</tr>
<tr>
<td>Lack of basic trust</td>
<td>32.0</td>
</tr>
<tr>
<td>Other</td>
<td>100.0</td>
</tr>
<tr>
<td>Those perceiving trade credit as common</td>
<td>46.0</td>
</tr>
<tr>
<td>Those who have experienced trade credit related dispute</td>
<td>81.8</td>
</tr>
</tbody>
</table>

**How trade credit disputes are resolved:**

<table>
<thead>
<tr>
<th>Resolution</th>
<th>Response level (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Used an arbitrator</td>
<td>8.8</td>
</tr>
<tr>
<td>Used the forces of law</td>
<td>7.8</td>
</tr>
<tr>
<td>Wrote off the debt</td>
<td>7.8</td>
</tr>
<tr>
<td>Dispute still pending</td>
<td>40.8</td>
</tr>
<tr>
<td>Used other method</td>
<td>6.9</td>
</tr>
</tbody>
</table>

**Ease with which trade credit disputes are resolved:**

<table>
<thead>
<tr>
<th>Ease with which</th>
<th>Response level (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Easy</td>
<td>5.8</td>
</tr>
<tr>
<td>Not so easy</td>
<td>29.2</td>
</tr>
<tr>
<td>Difficult</td>
<td>53.3</td>
</tr>
<tr>
<td>Don’t know</td>
<td>11.7</td>
</tr>
</tbody>
</table>

**Importance of reputation in attaining trade credit:**

<table>
<thead>
<tr>
<th>Importance</th>
<th>Response level (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very important</td>
<td>34.6</td>
</tr>
<tr>
<td>Important</td>
<td>48.8</td>
</tr>
<tr>
<td>Not important</td>
<td>11.0</td>
</tr>
<tr>
<td>Don’t know</td>
<td>5.5</td>
</tr>
</tbody>
</table>
More than 60% of the entrepreneurs also extend credit to their customers. 44% of those who do not extend credit fail to do so mainly because of problems with repayment. Another 32% are unwilling to offer credit due to lack of basic trust while others do not extend credit to customers due to poor capital base. Disputes related to trade credit seem common, as more than 80% of the entrepreneurs reported having suffered some trade credit related dispute. More than 50% of the entrepreneurs perceive the resolution of trade credit related disputes as difficult. Other studies (1997) have shown that small enterprises are particularly disadvantaged with regard to resolution of business related disputes. As a result, the majority of such disputes remain unresolved for a long time. Litigation costs and limited enforceability of contracts are therefore a major impediment to trade credit.

Although trade credit can have an important component of credit markets relevant to SSEs, the development of such credit is marred by poor contract enforcement. Entrepreneurs resolve this by establishing long-term relationships and good reputation with their suppliers. However, such relationships take time to evolve and may take root given the rather short life expectancy of these enterprises.

4.4 The Extent of Financial Layering

Data from the study shows that rotating savings and credit schemes are popular with SSE entrepreneurs. More than half the entrepreneurs report participation in such schemes (table 7). 68% of those so participating plough back the collections into their businesses. Another important application of collections from such schemes is purchase of durables. Although the usefulness of these schemes is limited (Kimuyu 1999), they are important in generating resources that are not otherwise available from traditional sources of credit. They also provide alternative credit sources to borrowers who face financial market failures.
Table 7: Evidence of Financial Layering

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Response rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participation in rotating savings and credit associations</td>
<td>57.8</td>
</tr>
<tr>
<td><strong>Method of keeping savings:</strong></td>
<td></td>
</tr>
<tr>
<td>Commercial banks</td>
<td>60.2</td>
</tr>
<tr>
<td>Savings groups</td>
<td>0.8</td>
</tr>
<tr>
<td>Purchase of property</td>
<td>0.8</td>
</tr>
<tr>
<td>Other</td>
<td>38.3</td>
</tr>
<tr>
<td><strong>Sources of funds for on-lending by money lenders:</strong></td>
<td></td>
</tr>
<tr>
<td>Businesses</td>
<td>52.0</td>
</tr>
<tr>
<td>Personal savings</td>
<td>17.9</td>
</tr>
<tr>
<td>Rotating savings and credit schemes</td>
<td>17.9</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>1.8</td>
</tr>
<tr>
<td>Multiple sources</td>
<td>7.1</td>
</tr>
<tr>
<td>Other</td>
<td>7.1</td>
</tr>
<tr>
<td>No response</td>
<td>23.2</td>
</tr>
<tr>
<td>Enterprises holding business accounts with formal financial institutions</td>
<td>58.6</td>
</tr>
<tr>
<td><strong>Types of accounts:</strong></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>10.5</td>
</tr>
<tr>
<td>Savings</td>
<td>89.5</td>
</tr>
<tr>
<td>Businesses having overdraft facilities</td>
<td>10.8</td>
</tr>
<tr>
<td>Accounts for business-related groups</td>
<td>77.1</td>
</tr>
<tr>
<td>Those viewing groups as having attracted financial services to towns</td>
<td>36.2</td>
</tr>
</tbody>
</table>
60% of the entrepreneurs reported that they deposited their savings with commercial banks. Interactions between commercial banks and SSEs are therefore evident. Observations from the field, however, revealed that due to recent changes in the banking regulations permitting minimum establishment of balances, most of the savings from the sector now end-up with the Post-Bank, which does not offer full banking services.

Although more than 40% of the entrepreneurs interviewed during the study were affirmative about the presence of moneylenders, most such lenders use funds from personal savings and rotating savings and credit schemes to on-lend to those needing credit. Only 1.8% reported that moneylenders borrow from commercial banks for on lending.

58% of the entrepreneurs intimated that they hold business accounts with formal financial institutions such as commercial banks, SACCOs, Post-Bank, or Co-operative societies. Nearly all such accounts are savings accounts. Only 10% of the enterprises in the study had overdraft facilities. 50% of the entrepreneurs belonged to a business-related group, and 77% of such groups held accounts with commercial banks. However, 36% of the entrepreneurs considered these groups as having been attracting financial services in their towns of operation.

Although there is evidence of linkage between SSEs and the formal financial sector either directly as when entrepreneurs hold accounts for their business and business-related groups hold accounts with financial institutions for such groups or indirectly such as through moneylenders, financial layering is limited. Networking through business related groups seems important in promoting financial layering, but recent changes in banking regulations seems to have reduced the extent of effective financial layering by pushing enterprise from commercial banks to other financial institutions that do not offer full banking services, including loans.

Post-Bank has the advantage of having many outlets, including some in small shopping centres spread throughout the country. These outlets receive savings from small timers such as SSEs and are therefore helpful in mobilizing savings in areas out of the reach of commercial banks. Even though most accounts are for saving and fixed deposits in nature, Post-Bank facilitates payments by cheque for their account holders. The bank’s minimum
balance requirements are relatively modest in comparison with those by commercial banks. SSEs can therefore use Post Bank to accumulate internal resources for expansion of business and for making new investment. The premium bond program has also helped in generating capital for starting businesses. However, Post Bank does not offer credit facilities. Since there is no obvious link between Post Bank and other credit offering financial institutions, holding an account in Post Bank does not promote the eventual development of reputation and credit-worthiness, both of which are important in increasing access to credit.

The Kenya Rural Enterprise Program (K-REP) is another successful NGO mandated to offer credit to small business. Its most innovative approach to micro financing has been in developing joint liability programmes for extending credit to different groups of borrowers, borrowing a leaf from the Grameen Bank of Bangladesh. Recently, K-REP formalizes its credit services into a bank with full banking services. The K-REP bank offers three loan facilities to both individuals and groups. The first of these includes small loans that are secured through joint liability. The second facility is a personal loan facility through which individuals with acceptable collateral can borrow up to a maximum of Kshs. 500,000. The last facility is a business loan facility through which small businesses can acquire credit up to a maximum of Kshs. 5 million. Loans extended under this facility have to be conveniently secured. In addition, the K-REP bank offers a wide variety of savings and fixed deposit facilities for individuals and groups with appropriate minimum balances.

The K-REP bank is a recent development in the micro finance scene, and has only five marketing offices, two in Nairobi, one in Embu, Nyeri and Eldoret. However, the bank is subject to all banking regulations and is unlikely to maintain its focus on micro financing. These regulations partly account for the fact that presently, most of the banks’ resources are held up in treasury bills rather than in small enterprises. The bank seems unable to exploit its full financial layering capacity due to the regulatory environment.
CHAPTER FIVE

5.0 Introduction
This chapter addresses the question under study and summarises the study’s main results, and providing recommendations on improving the supply of credit to SSEs.

5.1 Importance of Credit
Lack of working capital is the most important reason for business closure for more than a third of the enterprises. Lack of credit is the second severest problem faced by SSEs, the first one being lack of demand for their products/services. Reinvestment is the second most important use of retained earnings. Credit information needs are second in importance after information related to produce and service markets. The findings confirm that credit plays a crucial role in enterprise performance, and that most enterprises are aware of this.

5.2 Attitude Towards Borrowing
Most entrepreneurs view borrowing as both important and necessary for business pursuits. The majority perceive the impact of credit on businesses as positive, and would, when possible, borrow to save businesses from collapsing. Therefore, majority of SSE entrepreneurs have the right attitude towards borrowing.

5.3 Access to Credit
Despite the declared importance of credit and the positive attitude towards borrowing, only a small proportion of SSEs borrow. The majority of the entrepreneurs rely on limited own and family savings for start up and additional capital. They hardly rely on external sources of funds. Therefore, these enterprises have poor access to credit.

5.4 Supply of Credit
On average, the supply of credit nearly matches demand with an average gap of only 17%. Urban-located enterprises achieve a higher success rate than the rural ones. Similarly, informal enterprises are more successful in the levels of their loan applications than formal
ones. Even though the amounts applied for by informal enterprises are on average, smaller than amounts applied for by formal enterprises. Informal enterprises either have better perceptions about their success possibilities or have advance information on how much they hope to get from their credit sources. They are also likely to borrow from specific programmes with clear credit limits.

Other differences in loan application success rates relate to credit sources. Entrepreneurs applying to co-operatives receive most of what they request, while those applying to non-bank finance institutions are generally less successful in terms of level of credit sought than those applying elsewhere. Entrepreneurs borrowing from co-operative societies are likely to be personally known to the management of such societies, some of which are informal. This accounts for the higher success rate of entrepreneurs borrowing from this source. Econometric estimates of the conditional credit-supply function yield positive impacts of formality and urban location, as well as differential impacts of various credit sources. The estimations also pick up a strong positive coefficient for internal revenue on the supply of credit, confirming imperfections in the credit market.

The results also suggest the existence of quantum of unsatisfied demand for credit within the SSE sector.

5.5 Choice of Credit Source
The structure of credit source choice is influenced by formality status, gender of proprietor, location, membership to a support group and business activity in which an enterprise is engaged. Formality and gender are particularly important in accessing credit from commercial banks. Different types of enterprises and entrepreneurs have access to only specific credit sources, so that the credit market is structurally segmented.

5.6 Incidence of Trade Credit
Many entrepreneurs invest time in developing long-term relationships and good reputation with their suppliers. The short life expectancy of many SSEs reduces opportunities for building such relationships. Some entrepreneurs report receipt of supplier credit and much
more extended credit to their customers. But credit related disputes appear common and difficult to resolve due to difficulties in enforcing contract. This reduces the use of supplier credit and the benefits associated with it.

5.7 Financial Layering
There is little interaction between the SSE activities and different components of the relevant financial markets. Resources generated from the sector do not reach the commercial banks. Similarly, there is no evidence of movement of funds from commercial bank and other formal financial institutions to the SSE operatives. Recent reforms have weakened previous links between the sector and formal financial institutions and the current regulatory environment has reduced financial layering in the sector. Minimum balance requirements have pushed many small savers, including SSEs towards non-loan institutions where they have little opportunity for building credibility in time to borrow. Other banking regulations have reduced the capacity of institutions with a specific interest on SSEs to pursue their mandates. The K-REP bank is a perfect example of an institution struggling to keep mandate of financing small business under the weight of the existing banking regulation.

5.8 Strategies For Increasing Access To Credit By SSEs
The Kenyan financial system is marked by a dualistic structure, i.e. the financial sector breaks down into formal and informal financial markets. In developing countries such as Kenya, the reason why financial dualism arises is that the formal financial sector is underdeveloped, a fact, which is, reflected in an inadequate credit supply of formal financial actors, in particular banks, to SSEs. Informal financial suppliers partly compensate for this lack of financial services. However, the financial services provided by informal suppliers are also inadequate (Table 10). On the one hand, formal financial actors, such as banks, provide relatively large credit volumes for long periods at moderate interest rates, but the procedures take time and formal collateral or guarantors are required. The supply of long-term bank credits to SSEs is thus limited. In addition, the supply of short-term credits by banks is restricted because transaction costs are high. On the other hand, informal financial actors,
such as moneylenders and Rotating Savings and Credit Associations (ROSCAs) provide quick and easily accessible credit for short periods, and these suppliers are more flexible as regards collateral requirements, though conditions are insecure and interest rates are high. Although the strengths and weaknesses of formal and informal credit suppliers complement each other (Table 10), credit needs of SSEs in Kenya are not adequately satisfied.

Table 10: Strengths and Weaknesses of Credit Suppliers

<table>
<thead>
<tr>
<th>Financial Needs</th>
<th>Moneylender</th>
<th>ROSCAs</th>
<th>Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term credit</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Long-term credit</td>
<td>-</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>Small credit volume</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Large credit volume</td>
<td>(-)</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Quick disbursement</td>
<td>+</td>
<td>(+)</td>
<td>-</td>
</tr>
<tr>
<td>Flexible collateral</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Simple procedures</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Moderate interest rates</td>
<td>-</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

5.9 Principle Findings and Policy Recommendations

The present analysis has shown that one of the reasons why the credit needs of SSEs in Kenya are not adequately met is the gap between formal and informal credit suppliers. The dualistic structure of the Kenyan financial system is characterised by an inadequate credit supply of the formal and informal financial actors to SSEs.

Two approaches would be appropriate to improve the quality of credit access for SSEs: downscaling and modified upgrading. Since this gap between the formal and the informal financial sectors cannot be closed on the basis one of these approaches alone, a bridge has to be built from both sides, aimed at meeting in the middle and integrating the two sectors, or, in
other words, what is called for is a combination of a downscaling approach and a modified upgrading approach. The result would be a less strict division between the formal and informal markets. In addition, this would mean more competition between different suppliers. The answer to the research questions is that adequate access to credit for SSEs in Kenya can be improved only through more competition between the suppliers in an integrated financial system.

Downscaling of banks implies that banks enlarge their target group to include smaller clients who mainly obtain their credits from informal suppliers. In this way banks could adopt some of the strengths of informal credit suppliers. First, banks could reduce costs by simplifying procedures for small loans without leaving the formal framework. Second, like moneylenders, banks could accept a wider range of collateral because SSEs are often without the collateral required to obtain bank credits. Third, bank officers could approach customers in what is known as the so-called “Field Officer Approach”. In this approach the field officer establishes a closer relationship to the customer by linking the bank more closely to the client. Banks could implement more personalised relations to their SSE clients and improve their methods of checking customers. On the one hand, this would lower default costs because banks would in this case be in a better position to evaluate the financial capacity of their clients. However, on the other hand this would raise bank transaction costs.

Fourth, banks could increase their interest rates for small loans in order to realise profits, as is illustrated by the example of money shops, an approach that has been successfully introduced in the Philippines. The current credit supply practices of moneylenders indicate that SSEs are able to pay very high interest rates for flexible and quick credits.

The history of pawn broking in Kenya and money shops in the Philippines serve as examples to illustrate cases in which banks have successfully adopted lending techniques of informal credit suppliers.
Policy-makers could contribute to the process by establishing a legal framework to enable banks to implement the recommendations on downscaling.

Development organisations could support banks in developing micro finance programmes.

Upgrading informal financial sector actors means transformation of informal financial transactions in the direction of more formality and professionalism. Moneylenders have no incentives to formalise their business. Most moneylenders were reluctant to register their money lending business, which would require them to pay taxes, because this would not be of any advantage to them. However, the negative aspects of informality suggest that even without full upgrading a modified approach to upgrading moneylenders could contribute to a better credit supply.

This approach could be used to formalise the money lending business at least to some degree. The policy-makers could support an enlarged scope for the institution for the settlement of informal loan disputes.

ROSCAs do not have much potential to upgrade their activities, either. The majority of ROSCA organisers reported that they would not be interested in a more professional approach to organising one or even several ROSCAs, because the risk and responsibility involved in the organisation of a ROSCA are large. Similarly, enlarging the size of the group was also not an attractive option for most ROSCA members. The particular social character of their ROSCAs would suffer if too many members were accepted. In addition, the larger the groups, the less foreseeable the risks, and the greater the likelihood of delay and default. The only promising approach to a modified upgrading of ROSCAs would be to adopt some legal measures aimed at minimising the risks of delay and default for members as well as for organisers. On the one hand, introduction of some formal documentation for transactions in ROSCAs would conflict with the informal nature of ROSCAs.
On the other hand, introduction of contracts between members and the organiser would give a legal form to the rules of ROSCAs. Such contracts could be used in court in cases of default to recover at least a part of the money concerned. Kenyan policy-makers could promote better legal integration of ROSCAs.

5.10 Measures to Adjust the Legal and Institutional Framework

Additional measures could be used to support these approaches. For a lack of adequate collateral, SSEs are often unable to obtain large credits from banks. To improve this situation, it would be possible, to formalise assets of SSEs. In particular, SSEs are often unable to use land properties as collateral because there are no clear regulations on proving property rights, and land titles are as a rule not registered. Although solving this problem would be a time-consuming and costly process, policy-makers should promote the registration of land titles.

Since SSEs are often highly indebted, the following steps could help to avoid high indebtedness of SSEs or solve the problems of highly indebted SSEs. First, policy-makers could establish an advisory board for highly indebted SSEs. The board not only could provide advice in cases of heavy indebtedness, it should also help SSEs to assess more carefully their own financial capacities. Second, policy-makers could promote a fair and transparent insolvency process for SSEs by building a semi-formal institution to regulate insolvency procedures. SSEs which service outstanding loans by taking out new loans need be able to break out of this circle; this would be their only chance to start again with a new business.

In the matrix below is a summary of the strategies for addressing the institutional impediments that limit SSEs access to with a view to identifying specific impediment, reason for the impediments, and possible interventions for removing the bottleneck.
<table>
<thead>
<tr>
<th>Institutional impediment</th>
<th>Details of the problem</th>
<th>Corrective interventions/strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Less educated entrepreneurs show little interest in credit and also receive little credit</td>
<td>There is a possible positive correlation between an entrepreneur’s education level and ability to: - Pursue profitable entrepreneurship - Understand and familiarise with the working of credit/loan arrangements - Successfully manage loans.</td>
<td>Continue to expand educational opportunities to improve the literacy and numeracy of the pool of Kenyans from which the pool of entrepreneurs is drawn. - Encourage self-financing adult literacy classes for business persons</td>
</tr>
<tr>
<td>2. The current regulatory environment reduces SSEs’ access to credit</td>
<td>Existing regulations have a stranglehold on micro-finance programmes and institution extending financial services to SSEs.</td>
<td>Make the regulations more flexible by allowing use of collateral substitute for securing loans to SSEs. - Create exceptions to the minimum capital requirements for institutions that target SSEs. - Reduce entry and exit barriers in the financial sector to make the sector more contestable and therefore more customer friendly.</td>
</tr>
<tr>
<td>3. There is very low incident of supplier credit. This credit is an important supplement to other financial services.</td>
<td>- Businesses shy away from extending credit to their customers due to problems in enforcing contracts. - Inter-temporal transactions face opportunistic behaviour that has to be controlled through efficient law enforcement. - SSEs do not generally benefit from regular law enforcement channels due to high costs of legal redress and scale economies related to the small value of disputes.</td>
<td>- Establish dispute resolution mechanisms that can handle small claims cost effectively such as small claims courts. - Include the teaching of relational ethics and progressive norms in the curriculum for business training.</td>
</tr>
<tr>
<td>4. There are discontinuities in the flow of resources from SSEs to formal financial institutions and vice versa.</td>
<td>Considering limited saving/retained earnings by SSEs, and collateral and minimum balance requirements by commercial banks, there is very limited interaction between the two. - Attempts to link them through micro-finance institutions and other potential intermediaries are hampered by the regulatory environment. The result is limited financial layering.</td>
<td>Promote joint liabilities not just between groups of borrowers but also different levels of institutions. - Explore other methods of linking up commercial banks and other less formal financial institutional serving the SSE sector to create indirect links between SSEs and commercial banks. -Explore ways of promoting sustainable financial layering.</td>
</tr>
<tr>
<td>5. Given the importance of enterprise age in access to credit, short life expectancy of SSEs, especially informal ones, is an impediment to credit access.</td>
<td>The high mortality rate of SSEs means lost opportunities not only for accumulating business experience but also for building credibility and reputation that are necessary for accessing credit from financial institutions and suppliers of inputs and products. Most businesses die due to lack of credit.</td>
<td>Put in place, through the proposed Small Enterprise Development Trust, business clinics for extending managerial and financial first aid’. - Develop terms of reference for a study on enterprise survival and explore non-commercial risks peculiar to SSEs.</td>
</tr>
<tr>
<td>6. Informality inhibits access to credit</td>
<td>Although the SSE sector has limited access to credit, the informal segment has even less access than the rest of the sector, because of: - Uncertain legal status - Higher mortality rates - Less visibility -Low exit and entry barriers that create intense competition.</td>
<td>Develop mechanisms for mainstreaming informal enterprise such as reducing registration costs and delays whose avoidance necessitates informality.</td>
</tr>
</tbody>
</table>
SSEs are more likely to use internal sources, mainly retained-earnings and personal savings for working capital. This confirms that external capital is more costly than internal capital in Kenya.

The case of access to overdraft is not much different from that of formal credit, as far as predictions are concerned. The unique feature here is that entrepreneurs with high educational backgrounds are more likely to have access to overdrafts. This is consistent, because those entrepreneurs keep good accounting records and make savings with the banks regularly.

The researcher also stress that any entrepreneurship development programs must have a substantial component devoted to the training of accounting record keeping and bank transactions. This will increase the confidence the bank has in the SSE entrepreneurs and especially give them more access to overdraft.

The findings notwithstanding, I further recommend the following cost effective strategies to increase SSEs’ access to credit:

To reduce the high processing costs relative to small loan amounts and to minimize time-consuming project appraisals, banks should focus initially on working capital credit as against investment loans. Working capital loans may indirectly generate investment by successful firms, which are likely to plow back profits into expansion of capacity. Investment lending should be concentrated on SSEs that have already reinvested substantial internal resources but need supplementary external finance in order to move to a larger scale or higher productivity.

Risk can be controlled through character-based lending to entrepreneurs who have a good track record and close on-site monitoring. The cost of frequent monitoring can be minimized through greater decentralization of responsibilities for small loans provided local branch officers are adequately trained.

To expand small enterprise lending, banks need to develop alternatives to property as collateral to secure loans, such as personal guarantors, sales contracts, and liens on equipment financed. All of these, however, may depend on improvements in the ability of the legal system to enforce commercial contracts.
Limitations of the Study

It is important to bear in mind that after getting to the final version of the questionnaire, changes were discouraged because of the need to have a standard accepted uniform measurement instrument (Brewster et al., 1996). Moreover, the questionnaire was translated for all of the participating entrepreneurs.

In spite of the fact that it is possible for a self-administered questionnaire to produce honest responses, free of interviewer bias, the opinions and perceptions of the respondents could have influenced their answers (Mitchell and Jolley, 1992). Besides, a self-administered questionnaire includes another important limitation. The person that actually answers the questionnaire may not be the appropriate person (Zikmund, 1997). Even if it is the appropriate person that actually answers the questionnaire, it is based on his/her perceptions only in some questions.

In some enterprises interviews were used to collect the needed data and albeit this method provides the chance to explain further the concepts involved to the respondents, it is subject to interviewer bias and is not in accordance with the method used from the majority research done.

Moreover, the response rates of mail surveys are usually low, which means that both the validity and reliability of the results may be negatively affected (Field Work Procedures Resume, 1998).

Consequently, the generalization of the results of this study must be done with caution, since some samples may not be representative of the national economy, and the generalization should be limited to SSEs.

Another limitation of the study is a result of the context in which the empirical analysis was carried out. The fact that the study was focused on the small scale enterprises, with the wide range of activities which implies, and have concentrated on only one group of respondents, albeit the largest, means that the conclusions cannot be made applicable to all professions and sectors.
Appendix I

WORK PLAN

ACTIVITY

TIME (IN WEEKS)

1. Pilot study 1
2. Adjustments 1
3. Data collection 5
4. Data coding 6
5. Data analysis 7
6. Report writing 5
7. Compilation 5

TOTAL 30

TIME TABLE OF EVENTS

Table 1: TIME TABLE OF EVENTS

<table>
<thead>
<tr>
<th>PHASE</th>
<th>DESCRIPTION</th>
<th>NUMBER OF WEEKS</th>
</tr>
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<tbody>
<tr>
<td></td>
<td></td>
<td>1   2   3   4   5   6   7   8   9   10  11  12</td>
</tr>
<tr>
<td>I</td>
<td>Pilot study</td>
<td></td>
</tr>
<tr>
<td>II</td>
<td>Adjustments</td>
<td></td>
</tr>
<tr>
<td>III</td>
<td>Data collection</td>
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</tr>
<tr>
<td>IV</td>
<td>Data coding</td>
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</tr>
<tr>
<td>V</td>
<td>Data analysis</td>
<td></td>
</tr>
<tr>
<td>VI</td>
<td>Report writing</td>
<td></td>
</tr>
<tr>
<td>VII</td>
<td>Compilation</td>
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Appendix II

ESTIMATED BUDGET OF THE STUDY

<table>
<thead>
<tr>
<th>S/N</th>
<th>ITEM</th>
<th>AMOUNT KSH.</th>
</tr>
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<tbody>
<tr>
<td>A</td>
<td>Books and Reading Materials</td>
<td>20,000</td>
</tr>
<tr>
<td>B</td>
<td>Data Collection (Survey)</td>
<td>10,000</td>
</tr>
<tr>
<td>C</td>
<td>Research Assistants Remuneration and allowances</td>
<td>20,000</td>
</tr>
<tr>
<td>D</td>
<td>Data coding, analysis, estimation and computer run time.</td>
<td>15,000</td>
</tr>
<tr>
<td>E</td>
<td>Production of the report and printing materials</td>
<td>10,000</td>
</tr>
<tr>
<td>F</td>
<td>Contingencies and other miscellaneous</td>
<td>5,000</td>
</tr>
<tr>
<td>G</td>
<td>TOTAL</td>
<td>80,000</td>
</tr>
</tbody>
</table>
Appendix III

REFERENCES


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SPECIMEN LETTER TO THE RESPONDENTS

KENYATTA UNIVERSITY
SCHOOL OF HUMANITIES AND SOCIAL SCIENCES
DEPARTMENT OF FINANCE
P.O. BOX 43844,
NAIROBI.

To the Respondent,

RE: REQUEST TO CONDUCT A STUDY.

I am a postgraduate student researching on the topic “Sources of Finance Available to Small Scale Enterprises in Nairobi, Kenya”

You have been selected as one of the respondents in this study. I would like to request you to complete the questionnaire. The information supplied will be used strictly for academic purposes only and will be treated with utmost confidentiality.

Your cooperation will be highly appreciated.

Thank you.

Nalwelisie Chrisantus
1. Name of the business. .........................................................................................................................

2. Sub-Sector ........................................................................................................................................

3. Age ............................................................................................................................... Sex ........................................................

4. Do you have apprentices in your business?
   a) Yes  b) No

5. If yes, how many years have you been in apprenticeship?
   a. Less than an year
   b. 10 years
   c. Over 5 years

6. Is your business registered? ----------------------------------------

7. How do you finance your business?
   a. Loan from banks
   b. Personal savings
   c. By charging fees to trainees
   d. Rotating savings and credit associations
   e. Money lenders

8. Do you maintain financial books? Yes ------ No -------
   If yes, which ones?
   a) Cash book
   b) Student fee register
   c) Income statement
8. How do you market your training courses?

a) Through advertisements
b) Printing of brochures and distributing them
c) Others (specify please)

9. What is your level of education?

a) O-level
b) Technical college
c) University graduate
d) Standard eight

10. How do you manage your money income (fees paid by trainees)?

a) Bank
b) Invest
c) Other (specify)

11. If investments, where do you invest?

a) Plough back into the business
b) Buy treasury bills
c) Settle outstanding debts

12. Do trainees pay fees? Yes --------- No ----------

13. What proportion of fees paid by your trainee students is reinvested in your business?

a) 1% – 25%
b) 26% - 50%
14. Do students pay in time? Yes --------------  No --------------

15. If a student doesn't pay fees, what do you do?
   a) He is sent home
   b) He trains but doesn't receive pay
   c) Other (specify) ...........................................

16. Approximately how many trainees do you enrol per session?
   a) 5-10
   b) 11-20
   c) 21-30
   d) 31-40
   e) Above 40

17. Why do small scale enterprises business close in your area?
   a) Shortage of working capital
   b) Personal reasons
   c) Too few customers
   d) Started another business
   e) Competition

18. What is your source of initial capital?
   a) Loan/family funds
   b) Loan from friends
   c) Commercial bank
d) Rotating savings and credit associations

e) Others (money lenders, trade credit)

19. If through bank loans, moneylenders, do you attach security?
   a) Yes
   b) No
   c) Other (specify)

20. If you default on payment, what happens?
   a) Suit is filed
   b) Repossesses the asset

21. What is the interest rate per month?
   a) 7.8%
   b) 6%
   c) 20%

22. What do you use the loan for?
   a) As start up capital
   b) Working capital
   c) Investment capital

23. What is your opinion about borrowing?
   a) Necessary for business
   b) Do not mind it
   c) Do not like it

24. What is your preference if unable to continue without borrowing?
25. What is the impact of borrowing on your business?

a) Generally positive
b) Indifferent

26. How do you manage your collections?

a) Plough back into business
b) Participate in rotating saving and credit
c) Purchase property
d) Keep in bank

27. What type of bank account do you hold?

a) Current account
b) Savings account
c) Accounts for business related groups
d) Overdraft facility