

ETHICS AND GOVERNANCE IN SME'S – EAST AFRICA'S EXPERIENCE



Introduction;

The contribution of the Small and Medium Enterprises (SME's) to the economy of a nation is well recognized. In developing countries, it is believed, the contribution of SME's towards employment generation is significant because the following:

SME's

1. Tend to use more labour intensive production processes than large enterprises, boosting employment and leading to more equitable income distribution
2. Provide livelihood opportunities through simple, value adding processing activities e.g. in agriculturally based economies;
3. Nurture entrepreneurship; and
4. Support the building up of systematic productive capacities and the creation of resilient economic through linkages between small and large enterprises

While individually an SME may not have a significant impact on the economy like the large corporations do, their cumulative social and environmental impact is significant. This is already being witnessed in the textile and the cottage industries.



What are SME'S?

SME's are defined in different ways in different parts of the world. Some define them in terms of assets, while others use employment, shareholder funds or sales as criteria. Some would use a combination of revenue and employment to define SME's.

The definition of SME has been a contentious issue in the world. In fact, **the term**, SSI (Small Scale Industry) is more commonly used to refer to SME's.



Features of SMEs:

There are characteristics which distinguish SMEs from larger firms. Large firms often have direct access to international and local capital markets because they have an established structure i.e, governance while SMEs are often do not.

SME's cannot afford the high fixed costs of complying with regulations,.

Micro enterprises largely operate at a threshold which falls below the regulatory and Institutional constraints that inhibit other SMEs and, in some cases, would expand if the barriers to their operations were removed. Because high transactions costs are one of the most important barriers, their reduction will promote the creation and expansion of SMEs and, in particular, encourage micro enterprises to expand.

Example of SME in eastern African region



Women selling fresh vegetable at a local market



Origin of SME's in East Africa

Most SME's in East Africa started as family businesses. And many entrepreneurs come from a traditional business family background. Business family relations are important for new start up businesses, particularly in East African countries in which there is very little, if any, institutional support for small entrepreneurs.

The family has a dominant role in business continuity and survival, providing the financing (instead of banks), the moral support and the network within the country and the world.

Origin of SME's in East Africa cont'd

In East African countries many entrepreneurs inherit their businesses from their fathers and grandfathers or from close relatives. This group of owner-managers has a strong entrepreneurial background and their business is part of a family tradition.

In majority newly established enterprises the entrepreneurs has a family member who owns a business. In many cases, family members were generally encouraged to work in the same business or start a new one in the same line of business.





Where do SME's mostly operate in East Africa?

SME's in East Africa are engaged mostly in artisan activities, e.g. carpentry, masonry, barber/beauty saloon;

Food **vending** i.e. fresh food trade and meal preparation and sales; and petty trading.

Forms of SME'S

Most SME's operate as sole traders or family businesses. But some are partnerships or joint ventures and a few are registered limited companies. The transition from sole trader/ family business status to partnership or limited company status has been relatively slow.

Areas where most SME operate in Eastern African Region



Picture taken from the market place where most of the women are engaged in selling fresh vegetables

Areas where most SMEs operate in Eastern African Region



Women selling food commonly known as “Mama lische” in Tanzania



SOME OF THE CHALLENGES FACED BY SME'S IN EAST AFRICA (CONSTRAINTS)

SMEs face a variety of constraints owing to the difficulty of absorbing large fixed costs, the absence of economies of scale and scope in key factors of production, and the higher unit costs of providing services to smaller firms.

A. Input Constraints:

Debt & Equity:

SMEs have limited access to capital markets, both locally and internationally, in part because of the perception of higher risk, informational barriers, and the higher costs of intermediation for smaller firms. As a result, SMEs often cannot obtain long-term finance in the form of term debt and equity.

Labor Market:

An insufficient supply of skilled workers can limit the specialization opportunities, raise costs, and reduce flexibility in managing operations.



Input Constraints cont'd

Information & Technology:

SMEs have difficulties in accessing to appropriate technologies and information on available techniques. This limits innovation and SME competitiveness. At the same time, other constraints on capital, and labor, as well as uncertainty surrounding new technologies, restrict incentives to innovation.

Production inputs:

SMEs face problems of the availability of production inputs. E.g. better quality raw materials are generally exported or are available only to larger firms and their suppliers tend to be oligopolies. Inadequate infrastructure and weak provision of basic services such as transportation, energy, urban planning and production sites represent particular impediments for SMEs

B. Output Constraints:

Domestic Markets:

The diminished role of the state in productive activity and renewed private investment has created new opportunities for SMEs. However, limited access to public contracts and subcontracts, often because of cumbersome bidding procedures and/or lack of information, inhibit participation in these markets. Furthermore, inefficient distribution channels and their control by larger firms pose important limitations to market access for SMEs.

International Competition:

Previously insulated from international competition, many SMEs are now faced with greater external competition and the need to expand market share. Limited international marketing experience, poor quality control and product standardization and little access to international partners, however, impede expansion into international markets.

C. Regulatory Constraints

Taxation & Tariffs:

Complicated and inefficient tax codes that include cascading sales taxes and stamp duties are least favorable to SMEs and artificially promote larger-scale firms . At the same time, the tariff and non-tariff barriers which favor larger firms that play a role in policy making are often biased against SMEs.

Legal:

High start-up costs for firms, including licensing and registration requirements, can impose excessive and unnecessary burdens on SMEs. The high cost of settling legal claims and excessive delays in court proceedings adversely affect SME operations. The absence of antitrust legislation favors larger firms, while the lack of protection for property rights limits SME access to foreign technologies.

C. Regulatory Constraints cont'd

Capital Movements:

Even though most countries have significantly relaxed restrictions to capital movements, bureaucratic complications and distortions in the foreign exchange markets remain. These tend to affect SMEs most because of their small sizes.

Labor Markets:

Inflexible labor codes and other indirect labor costs bear most heavily on SMEs, raising their cost of doing business and depriving them of the flexibility to adapt.

D. Management Constraints:

Management skills and training:

Even though SMEs tend to attract motivated middle managers, they generally cannot compete with larger firms. The scarcity of management talent, prevalent in most countries of the region, has a magnified impact on SMEs.

Consulting Services:

The lack of support services or their relatively higher cost hamper SME efforts to improve their management because consulting firms often are not equipped with appropriate cost effective management solutions for the scale of SMEs. Furthermore, the little awareness, absence of information and/or time to take advantage of existing services results in weak demand for them.

E. Institutional Constraints:

Association and collective action:

Associations providing a voice for the interests of SMEs in the policy-making process have had a limited role compared to those of larger firms. Many of the entrepreneurs' associations have yet to complete the transition of their goals from protectionism to competitiveness. Moreover, the potential economies of collaborative arrangements in production and sale among SMEs have not been adequately explored.



ETHICAL CHALLENGES FACING SME'S

Ethics demands integrity, transparency and fair play in all dealings with each party the business is involved with; customers, the government and the public as a whole.

Integrity issues: Honesty and transparency is a big challenge among SME's

Trust :between individual business persons and between the enterprise and the public

Fraud: tax frauds and enterprises defrauding each other. Opportunity to expand tax base becomes difficult to be taken.

ETHICAL CHALLENGES FACING SME'S cont'd

Governance

Since majority of SME's in East Africa are family-owned enterprises there is the lack of separation of ownership from control implying that there is no distinction between shareholders/directors and managers. This leads to credibility problems as there is no system of checks and balances between shareholders, directors and managers.

The duties and responsibilities, and privileges of family members are not clearly defined. Thus *corporate governance* is lacking in this organization. Good corporate governance leads to development of a framework that provides adequate protection to the interests of stakeholders and reinforces the fiduciary responsibilities of those vested with the authority to act on behalf of the stakeholders.

Corporate governance encourages companies and those who own and manage them to achieve their corporate objectives through a more efficient use of resources. Moreover, corporate governance framework should recognize the rights of stakeholders as established by law.



Governance cont'd

Corporate governance is a significant factor in improving economic efficiency and growth. It has been empirically tested that good governance practices of a company gives a positive signal to investors. And where it is lacking, as in most SME's, investors raise a lot questions.

With the globalization of markets, international capital flows have become extremely valuable source of external financing. It is essential for companies to observe good corporate governance standards in order to competitively operate in the global capital market and to attract long-term foreign capital.

Foreign Direct Investment, which leads to the transfer of technology, is an important factor for economic progress of developing countries. Both the foreign and local investors give importance to good governance practices.



Structure

The ethical challenges make it difficult for SME's to have proper structures which are essential to good corporate governance. SME's In East Africa are small and remain small. This makes access to big finance difficult or even impossible.

Access to equity and finance is a major constraint to SME growth in many developing countries. The exiting structure of financial sector only serves large enterprises and commercial banks usually apply conservative policies when they are considering lending to SMEs. Majority of the banks consider lending to SMEs risky and unattractive venture due to a range of factors including information asymmetries and consequently high transaction costs, collateral requirement, financial products not meeting SME sector requirements in medium to long-term

Structure cont'd

Due to their small size, it is common for SMEs to shy away from formal modes of financing. SMEs do not approach formal financing for the following reasons:

1. High cost of credit
2. Documentation and procedures required for accessing formal finance are lengthy and cumbersome
3. Long processing time
4. Collateral requirements
5. Most of the SMEs are not registered i.e. working in informal sector and therefore would need to enter into formal economy and consequently face regulations
6. Disclosures would attract taxes and the burden imposed by inefficient tax authority
7. Disclosure of information cause the firm to lose confidentiality vis-à-vis its competitors
8. Perception that banks will start interfering in the internal affairs of the firm
9. Lack of information on benefits of corporate governance



Information

Reliable and correct information is difficult to get from SME's. Reports produced for third parties are in most cases not true. The enterprises would rather not produce any report at all. Keeping records is expensive thus most of the SME's do not keep have information about their business or dealings. Therefore getting reliable or correct information from them is a very hard exercise

Growth Opportunities

Because of ethical issues, growth opportunities are lost.

1. Partnerships, mergers and joint ventures do not get formed and those which formed do not last long
2. Accesses to finance become difficult for various reasons explained earlier.



WAY FORWARD AND ROLE OF GOVERNMENTS

Education

Business education needs to be given at all levels; from schools and colleges to small entrepreneurs and government agencies. Appropriate emphasis on Business Ethics should be given in the respective syllabi.

Creation of a level playing field

In order to promote the development and growth of SMEs the institutional and regulatory barriers which are biased against SME's should be reduced.

The key policy areas are in input markets (capital, labor availability and qualifications, technology, production inputs), output markets (pricing, anti-competitive policies, access to market information), and regulations (tax, tariffs, procurement, legal, capital movements)

Lowering transactions costs of business

To the extent that it is practical, Bank Programs should lower financial and economic transaction costs. It is recognized that the fixed costs of doing business are less easily absorbed by smaller firms than by larger ones.

Therefore, efforts to reduce bureaucratic procedures, enhance access to credit, eliminate unnecessarily restrictive labor practices, and expand the availability of market-related information will benefit SMEs to a greater degree.

WAY FORWARD AND ROLE OF GOVERNMENTS cont'd

Targeted programs

Eliminating institutional biases and lowering transactions costs are necessary, but not sufficient steps are taken to promote SMEs.

In cases where SMEs do not have access to the necessary inputs because of the failure of the market to provide them, the government can promote the provision of services and information through local and international institutions that fill these gaps.

Transfer of techniques and institution building

The government should ensure successful transfer of the techniques and capacity to support SME development the Government should seek to establish linkages among the actors -- with a special focus on those in the private sector – to encourage the interchange of policy lessons and experiences (within and between countries), develop the necessary local research and policy analysis on SME issues and encourage a policy dialogue on relevant issues.



The End

Thank you for listening