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# Why Are There So Few Black-Owned Firms in Africa? Preliminary Results from Enterprise Survey Data

By Vijaya Ramachandran and Manju Kedia Shah

**Abstract**

Much of the growth in Sub-Saharan Africa in the past decade has come from extractive industries, rather than from private, entrepreneurial activity. Furthermore, non-extractive activity in the private sector is often dominated by firms owned by ethnic minorities. This paper analyzes the characteristics of the *formal* private sector in five countries in sub-Saharan Africa, with a particular emphasis on Black African-owned (indigenous) firms. We find that indigenous firms start smaller and grow more slowly; however their rate of growth is positively influenced by whether the owner-entrepreneur has a university degree. We do not find overwhelming evidence that credit is the binding constraint but we do find that indigenous firms get less access to trade credit than firms owned by minority entrepreneurs. Finally, we discuss policy solutions that might enable a larger number of indigenous entrepreneurs to enter and survive in a vibrant, multi-ethnic private sector.

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# 1. Introduction

Much of the discourse on economic development and the private sector has focused on the role of foreign direct investment. While it is clear that foreign investment can play an important role in generating growth, it is also increasingly evident that countries cannot grow without a vibrant, domestic private sector. Ultimately, it is not foreign aid but rather privately generated profits which are the source of economic growth and poverty alleviation. In this paper, we will analyze the constraints faced by domestic firms in five countries in sub-Saharan Africa—Kenya, Tanzania, Uganda, Senegal, and Benin--with a view to identifying policy solutions that will help indigenous entrepreneurs to enter and survive in the private sector.

Several similarities exist across the countries in our sample. All have a history of colonization by European countries, and all have pursued post-independence industrialization strategies that focused on import-substituting industrialization and the creation of a large state-owned sector. This in turn led to the emergence of inefficient, dualistic manufacturing sectors, where a large number of informal and small firms coexisted with some relatively large capital intensive firms. All countries adopted World Bank-initiated structural adjustment programs in the 1980s or 1990s to reform their economies and pursue outward oriented growth. However, their manufacturing sectors remain small and fragmented—the majority of manufacturing remains under the control of either the state or minority ethnic groups, which account for much of the non-extractive employment generation in the private sector. Understanding why Black-owned firms in the formal private sector tend to be few and small is important because further broad-based growth of manufacturing can only occur with the participation of domestic firms, including the indigenous majority.

## Indigenous and Minority-Owned Firms in the Formal Private Sector

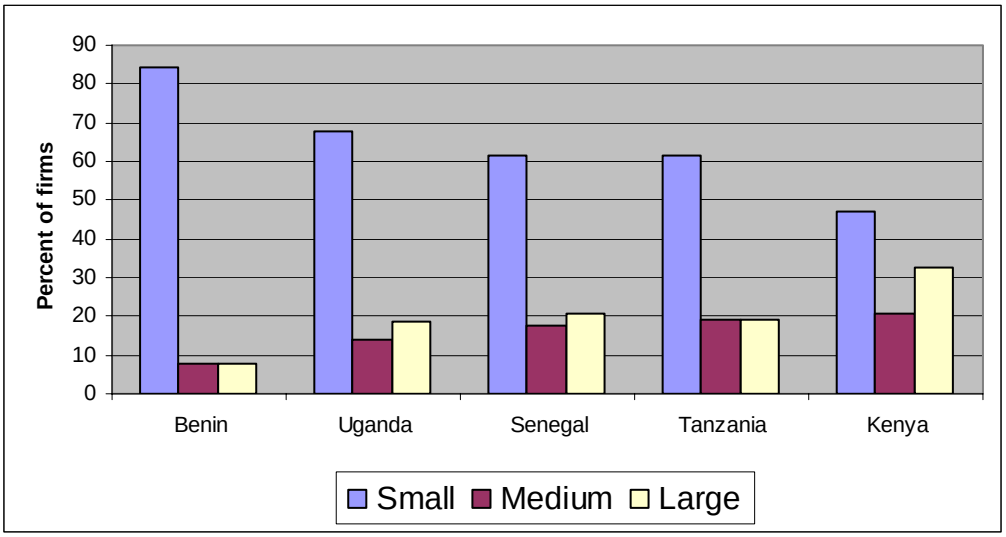
This analysis is based on data obtained from the World Bank's Investment Climate Enterprise Surveys. These surveys are conducted by door-to-door visits to firms, and cover the manufacturing sector for all countries as well as other sectors such as services, tourism etc. Using a stratified, random sample of firms in each country, the surveys focus on gathering information for the measurement of firm-level productivity and the characteristics of the investment climate in which firms operate. A standardized core questionnaire used in all countries which enables benchmarking on the crucial variables of investment, employment growth and productivity. The data used covers the formal sector only and looks at ownership in this sub-sector of the economy. Anecdotal evidence suggests that the informal sector is almost entirely made up on indigenous actors, but this sector is not the subject of this analysis. Forthcoming research will focus on the characteristics of the informal sector in Africa.

In this analysis, we use the investment climate survey data for five African countries (Kenya, Uganda, Tanzania, Senegal and Benin), all of which were surveyed during the

period 2002-04. Using these data, we aim to identify key characteristics of the *indigenous* entrepreneur-owned firms in the formal private sector, in contrast to other types of firms.

We begin by looking at the size distribution of firms in our sample (Figure 1). It is clear that the vast majority of firms in Africa are small (between 10 and 49 workers) as opposed to medium-sized (between 50 and 199 workers) or large (over 200 workers) .

**Figure 1: Size Distribution of Firms in the Survey Sample**




Further differences are revealed when we disaggreate domestic entrepreneur-owned firms by ethnicity of the owner. Figure 2 shows the average firm size of an indigenously-owned firm vs. a firm owned by an entrepreneur from a minority ethnic group (i.e. of Asian, Middle Eastern or Caucasian descent). We see that indigenous-owned firms are the smaller—most are well below 50 workers—whereas minority ethnic owned firms are substantially larger in all the countries reported in Figure 2.[1]

[1] We do not look at the informal sector in this paper, that is the subject of forthcoming work. A first look at the data suggests that this sector is dominated by indigenously-owned firms. The question that we will examine is—why don't more of these firms cross over to the formal sector?

**Figure 2: Average Firm Size by Ethnicity of Owner**

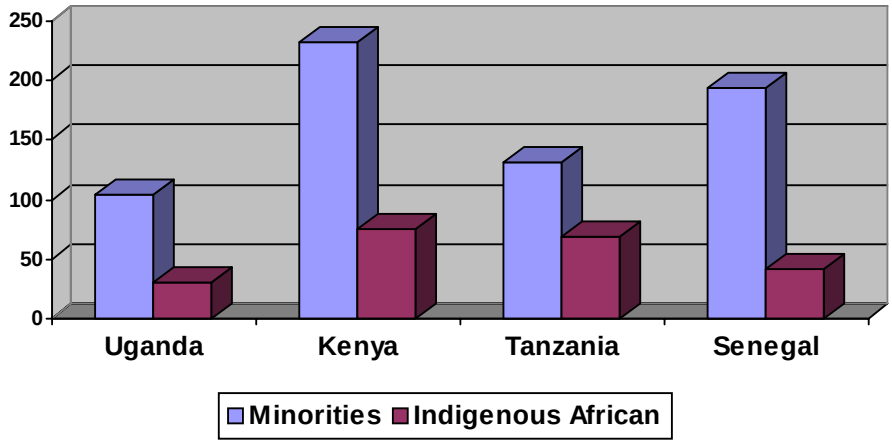



Figure 3 shows that indigenous-owned firms enter the market at a significantly smaller size than minority ethnic-owned firms. While the average firm size at startup of minority-owned firms in Tanzania is about 100 employees, that number is just under 40 employees for an indigenously-owned firm. For most countries where we have these data, the difference in startup size is close to 50 percent.

**Figure 3: Entry-level Size of Indigenous and Minority-Ethnic Owned Firms**

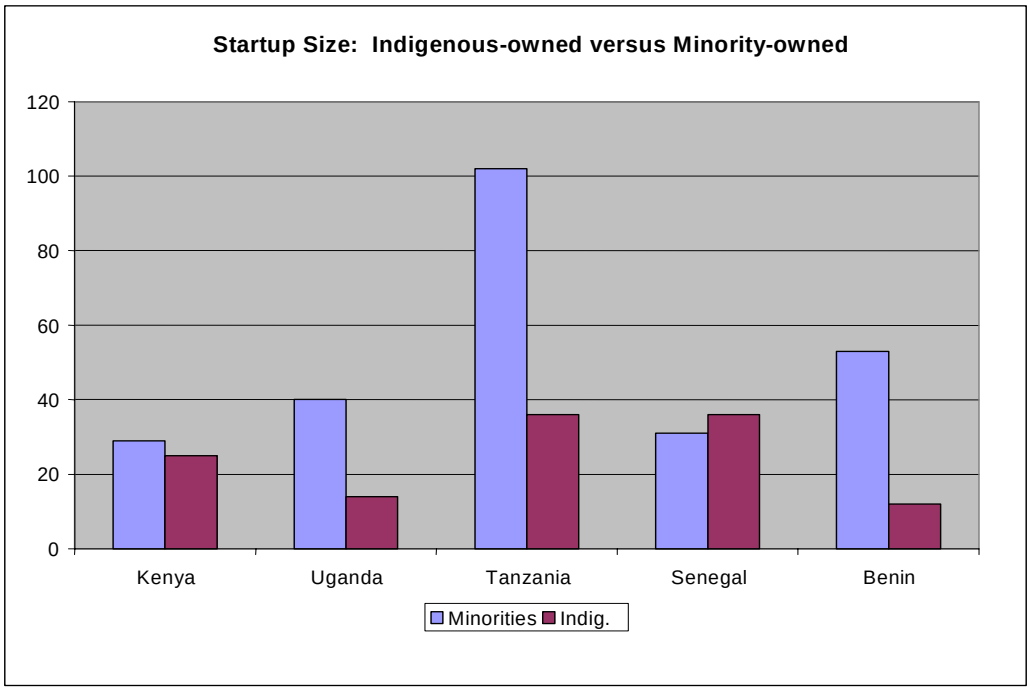
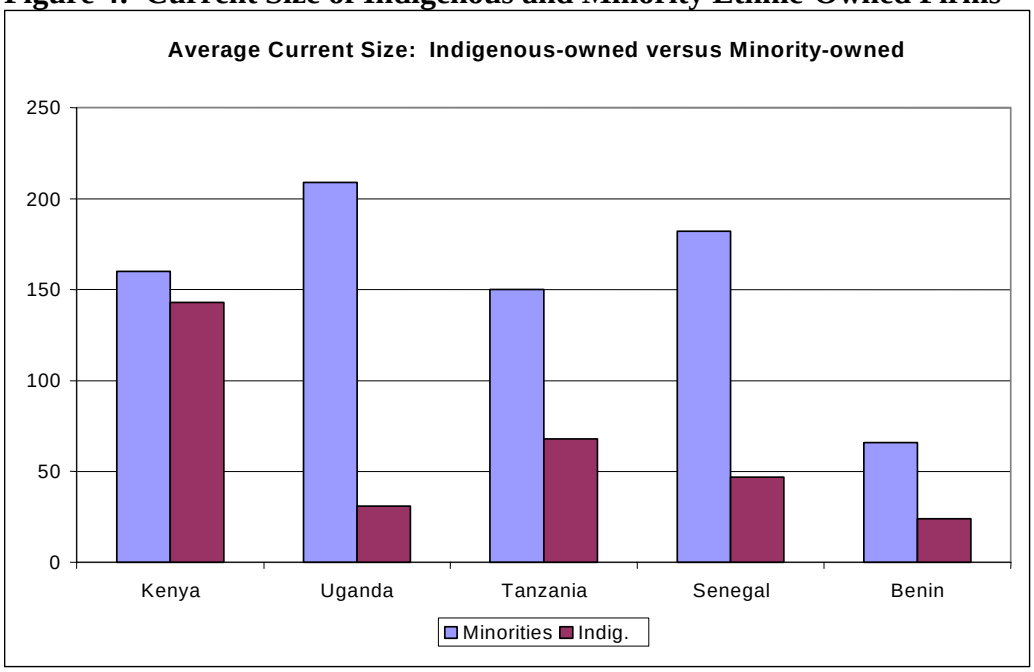



Figure 4 sums up the differences in *current* size, aggregating across all minority groups. We see that the difference in startup size persists over time, the difference in size at time of survey is not much different than the difference in size at startup and that in many cases, a large gap emerges over time between indigenous and minority entrepreneurs.

**Figure 4: Current Size of Indigenous and Minority Ethnic-Owned Firms**




Our data show that minority-owned firms start operations at a significantly larger size than indigenous African-owned firms. But the data also show that not all indigenous entrepreneurs start small. Further disaggregation of indigenously-owned firms shows that for indigenous entrepreneurs, education is very important in determining the size at which they start operations. Indigenous entrepreneurs with a university education start much larger firms compared to those that do not have a university degree in all countries surveyed, as described in Figure 5.[2]

[2] There are other analyses of the role of ethnicity in the private sector in Africa. Most notable is that a study by Taye Mengistae which looks at the role of ethnicity in the indigenous private sector in Ethiopia (Mengistae, 2001). More recently, Marcel Fafchamps examines the dynamics of the private sector, including the role of ethnicity, in a comprehensive analysis of markets in sub-Saharan Africa (Fafchamps, 2004).

**Figure 5: Entry-level Firm Size vs. Attainment of University Education**

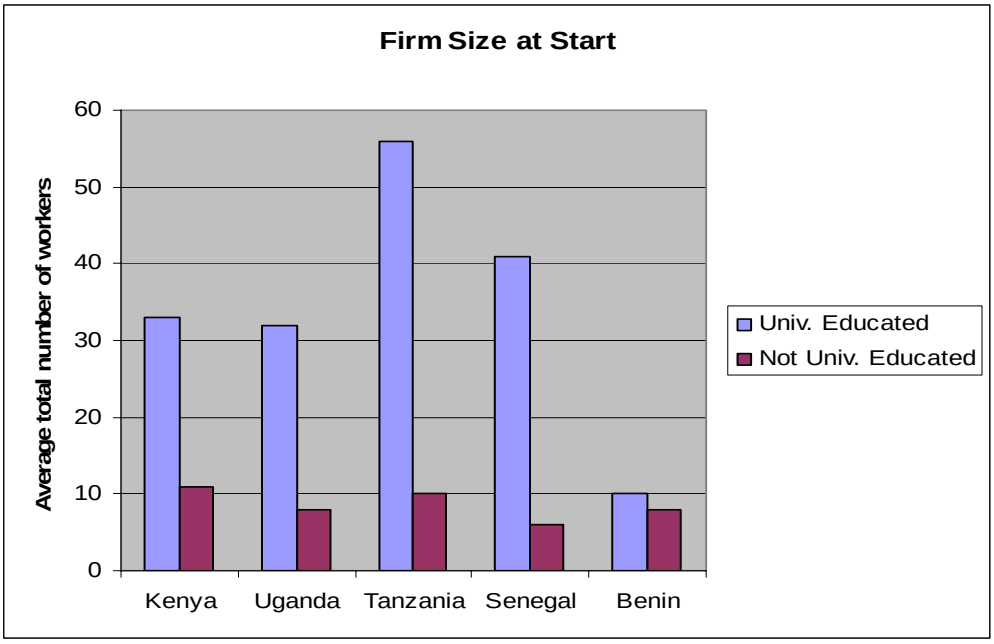
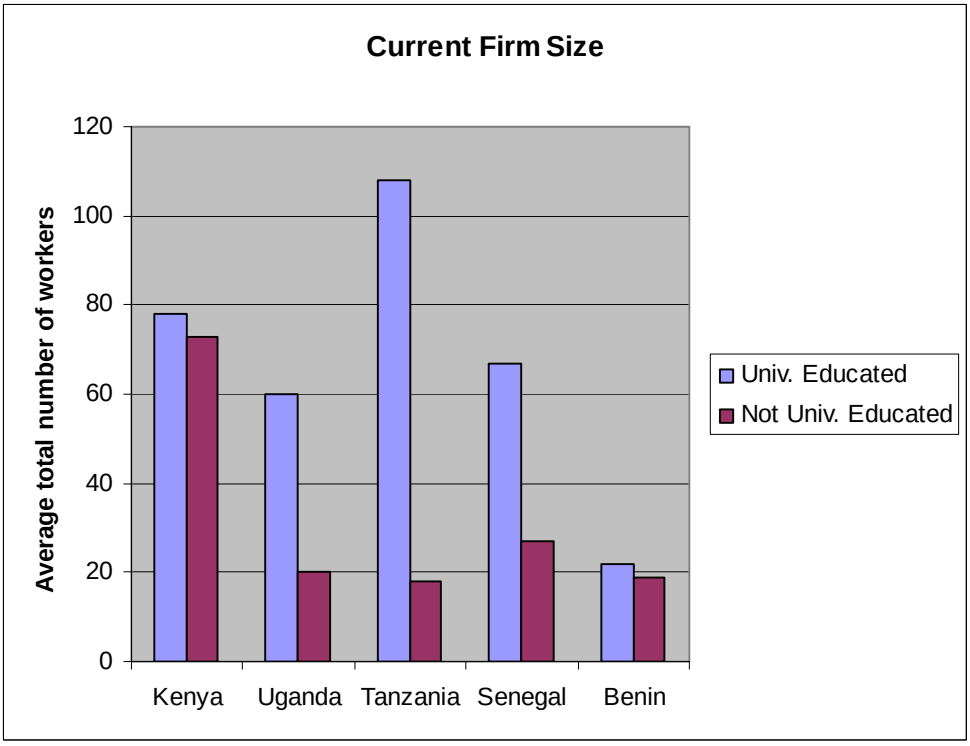



Figure 6 shows that the difference in size persists over time in most countries. Size at the time of survey is also higher for indigenous entrepreneurs with attainment of a university education than for those without such an education.

**Figure 6: Current Firm Size vs. Attainment of University Education**



Summing up the data above, Tables 1-3 describe key firm characteristics by region. Table 1 describes the size of firm at the start of operations, current size of firm, and age of firm, disaggregated by ethnicity of owner-entrepreneur (the figures in parentheses are standard errors). We see that in East Africa, minority ethnic-owned firms are over twice as large at start-up and that this gap widens over time; these firms are on average, 2.6 times the size of indigenous firms at the time of survey. Minority ethnic owned firms are also older (20.4 years vs. 11.8 years), which may reflect a greater ability to survive shocks, among other things. A similar pattern holds for West Africa. Firms in this region are in general, smaller and younger than firms in East Africa. But here too, indigenous firms are half as big as minority-ethnic owned firms. The gap widens much more over time, minority firms are over five times as large as indigenous firms at time of survey. Interestingly, there is not much difference in age of firm, just in the rate at which they grow over time.

**Table 1: Characteristics of Indigenous vs. Non-indigenous Entrepreneurs**

| | **All East African Firms** | **Indigenous East African** | **Non-Indigenous East African** | **All West African Firms** | **Indigenous West African** | **Non-indigenous West African** |
|---|---|---|---|---|---|---|
| Size of Firm at Start | 38.6 (140.5) | 23.6 (67.3) | 53.6 (186.0) | 19.3 (69.3) | 15.3 (58.1) | 33.8 (99.3) |
| Current Size | 95.3 (207.3) | 52.6 (137.7) | 138.1 (251.9) | 62.9 (306.4) | 31.5 (50.8) | 178.1 (645.3) |

Table 2 describes firm size by whether or not the owner-entrepreneur has a university degree. We see that indigenous entrepreneurs with a university education have firms that start larger and stay larger. This is true in both East and West Africa. Indigenous entrepreneurs in East Africa who have a university education are starting firms that are on average, five times larger than those where the entrepreneur does not have a university degree. And the advantage is maintained over time, current size of firms owned by a university-educated entrepreneur is three times as large as firms where the entrepreneur does not have a university degree. Interestingly, the gap is much smaller for minority-owned firms; not being university-educated is less of a disadvantage for this group when it comes to starting and growing a firm. There are two possible interpretations of the result regarding the impact of university education—that the completion of a university degree reflects a higher ability that is also responsible for entrepreneurial success and/or that the university degree enables access to a network of other business professionals that is useful for the success of the business. The difference in the results for minority vs. indigenous entrepreneurs implies that the network effect may be significant; further research to investigate the network effects of a university education or other types of training will be carried out to explore this result fully.

**Table 2: Firm Size by University Education in East Africa**

| | **Indigenous East African with univ. degree** | **Indigenous East African without univ. degree** | **Non-Indigenous East African with univ. degree** | **Non-indigenous East African without univ. degree** |
|---|---|---|---|---|
| Start-up Size | 54.2 (114.4) | 10.6 (19.3) | 64.0 (224.4) | 40.6 (121.3) |
| Current Size | 109.8 (219.1) | 28.3 (69.5) | 166.9 (284.2) | 101.9 (199.6) |
| Age of Firm | 14.9 (15.2) | 10.5 (7.9) | 18.3 (14.1) | 23.0 (17.7) |

Table 3 describes the results for firms in West Africa. We again see that indigenous entrepreneurs with a university degree are at an advantage. However, in contrast to East Africa, this advantage seems to hold for non-indigenous firms as well—these are twice as big when the entrepreneur is university-educated.

**Table 3: Firm Size by University Education in West Africa**

| | **Indigenous West African with univ. degree** | **Indigenous West African w/o univ. degree** | **Non-Indigenous West African w/ univ. degree** | **Non-indigenous West African w/o univ. degree** |
|---|---|---|---|---|
| Start-up Size | 33.5 (102.1) | 7.2 (9.7) | 49.2 (135.0) | 22.9 (62.4) |
| Current Size | 50.1 (68.1) | 23.3 (38.3) | 250.5 (941.1) | 126.4 (296.6) |
| Age of Firm | 14.8 (17.7) | 12.6 (9.6) | 14.9 (13.8) | 10.8 (8.6) |

Building on these results, we formulate a simple econometric model that enables us to test hypotheses regarding the determinants of start-up size and firm growth. Our cross-sectional data do not allow us at this stage to develop an identification strategy that would lead to conclusive results on causality. But we can look at *correlations* between firm growth and variables such as age, size, and educational attainment. We can do this for the entire sample as well as for indigenous and non-indigenous firms separately. In particular, we look at two key variables--access to finance and attainment of a university degree--to see if these are correlated with start-up size and rate of growth. The results of this exercise are presented in Tables 4 and 5.

The first regression looks at the determinants of start-up size for the whole sample; the next two regressions separate out indigenous and non-indigenous firms (Tables 4 and 5).

We see that whether or not an entrepreneur has a university education is significant in determining start-up size, as is his/her access to a formal loan. However, upon disaggregating the sample, we see that these variables *are only significant for indigenous firms*. The econometric model as a whole is not significant for non-indigenous firms, indicating that startup size is driven by other factors. We get similar results for West Africa; university education is significant for indigenous entrepreneurs but not others in determining startup size. Access to finance is not significant. We do see that Gibrat's Law holds—firms that are older and bigger at start grow more slowly. Both university education and access to a loan at start-up are also significant for the whole sample.

University education is significant for indigenous entrepreneurs in both East and West Africa, upon disaggregating the sample, and formal loans help only non-indigenous entrepreneurs in East Africa. The variable that is consistently significant throughout these estimations is university education, which helps indigenous firms grow at a higher rate in both East and West Africa.

**Table 4: Estimation of Startup Size in Africa**
**Dependent variable is Start-up Size**

| **Independent Variable** | **(East Africa all firms)** | **(East Africa indig. firms)** | **(East Africa Non indig. firms)** | **(West Africa—all firms)** | **(West Africa—indig. firms)** | **(West Africa—non-indig. firms)** |
|---|---|---|---|---|---|---|
| Intercept | 1.74*** (0.29) | 1.78*** (0.42) | 1.86*** (0.47) | 1.02*** (0.23) | 0.89*** (0.25) | 1.89*** (0.56) |
| Log(experience) | 0.08 (0.05) | 0.05 (0.07) | 0.04 (0.07) | -0.03 (0.05) | -0.01 (0.06) | -0.05 (0.11) |
| Secondary Education | 0.21 (0.18) | 0.05 (0.19) | 0.26 (0.38) | 0.23 (0.16) | 0.21 (0.17) | 0.05 (0.47) |
| University Education | 0.76*** (0.19) | 0.94*** (0.21) | 0.40 (0.36) | 0.78*** (0.18) | 0.82*** (0.20) | 0.15 (0.48) |
| Formal Loan at Start | 0.38** (0.15) | 0.55** (0.24) | 0.18 (0.21) | 0.02 (0.22) | 0.03 (0.27) | -0.21 (0.42) |
| Informal Loan at Start | -0.32 (0.19) | -0.44 (0.29) | -0.48+ (0.25) | -0.29 (0.22) | -0.36 (0.26) | -0.09 (0.45) |
| Uganda | -0.28 (0.15) | -0.37 (0.25) | 0.12 (0.22) | | | |
| Tanzania | 0.09 (0.19) | -0.32 (0.29) | 0.66** (0.29) | | | |
| Benin | | | | -0.003 (0.13) | 0.07 (0.15) | 0.29 (0.47) |
| N | 451 | 234 | 216 | 323 | 244 | 65 |
| R-squared | 0.13 | 0.20 | 0.05 | 0.17 | 0.17 | 0.05 |

Note: Only the subset of entrepreneur-owned firms is used in these estimations. Coefficients on sector dummies are not reported in the table.

**Table 5: Estimation of Firm Growth**
**Dependent variable is the Annual Rate of Growth of Employment**

| **Independent Variable** | **(East Africa all firms)** | **(East Africa indig. firms)** | **(East Africa non Indig. firms)** | **(West Africa all firms)** | **(West Africa indig. firms)** | **(West Africa non-indig. firms)** |
|---|---|---|---|---|---|---|
| Intercept | 0.62*** (0.04) | 0.57*** (0.07) | 0.71*** (0.06) | 0.61*** (0.04) | 0.57*** (0.05) | 0.73*** (0.10) |
| Log(employment at start) | -0.06*** (0.006) | -0.08*** (0.01) | -0.05*** (0.007) | -0.05*** (0.008) | -0.07*** (0.009) | -0.02 (0.02) |
| Log (age) | -0.14*** (0.009) | -0.12*** (0.01) | -0.16*** (0.01) | -0.14*** (0.01) | -0.13*** (0.01) | -0.20*** (0.02) |
| Secondary Education | 0.04** (0.02) | 0.03 (0.03) | 0.02 (0.03) | 0.03 (0.02) | 0.03 (0.03) | 0.02 (0.07) |
| University Education | 0.08** (0.02) | 0.10*** (0.03) | 0.03 (0.03) | 0.05 (0.03) | 0.06** (0.03) | 0.05 (0.07) |
| Loan at Start | 0.06*** (0.02) | 0.03 (0.03) | 0.07*** (0.02) | -0.02 (0.03) | -0.02 (0.04) | -0.11+ (0.06) |
| Informal Loan at Startup | 0.004 (0.03) | 0.05 (0.05) | -0.04 (0.03) | 0.03 (0.03) | 0.05 (0.04) | -0.004 (0.07) |
| Uganda | -0.08*** (0.02) | -0.04 (0.04) | -0.08** (0.03) | | | |
| Tanzania | -0.05** (0.02) | -0.05 (0.04) | -0.02 (0.02) | | | |
| Benin | | | | -0.08*** (0.02) | -0.07*** (0.02) | -0.21*** (0.06) |
| N | 578 | 290 | 287 | 331 | 261 | 69 |
| R-squared | 0.43 | 0.38 | 0.53 | 0.44 | 0.41 | 0.53 |

Note: Only the subset of entrepreneur-owned firms is used in these estimations. Coefficients on sector dummies are not reported in the table.

These results show that indigenous firms start smaller and grow more slowly but that attainment of a university education is significant in driving growth for this type of firm. This result has been obtained in prior analyses of firm growth, carried out with data from the 1990s (Ramachandran and Shah, 1999). One possible explanation is that a university education imparts much-needed skills to operate and grow a business and to survive exogenous shocks. The more likely explanation is that a university education provides access to a network of business professionals that in turn enables access to knowledge, capital and other inputs that are necessary to firm survival and growth.

## Access to Credit, Cost of Credit and Reasons for Not Applying for Credit

Another important aspect of the investment climate is the scope of the financial market—in particular, access to credit, cost of credit, and why firms do not apply for credit. The use of the formal financial differs quite a bit across countries—firms in Tanzania and Senegal have deeper financial systems and greater access to finance than firms elsewhere in Africa (Eifert, Gelb and Ramachandran, 2005). The average cost of a loan in Africa is higher than in India, China, and Morocco—in some cases, interest rates are over 20 percent. Collateral requirements are also quite significantly over 100 percent of the loan for several countries in Africa. In many cases, collateral is restricted to land in the capital city or to overseas real estate (such as an apartment in London or Paris), which could be readily seized in the event of non-payment.

Table 6 shows the percentage of firms with trade credit, overdrafts or loans and the percentage that applied and were rejected.[3] We see that about two-thirds of firms have trade credit in most countries, while the percentage of firms with overdrafts varies a great deal, ranging from just over 20 percent to over 63 percent in Kenya. The percentage of firms that currently have a loan also varies quite a bit, with Senegal having the highest percentage and Tanzania the lowest. Finally the percentage of firms that applied for a loan and were rejected is about 6 percent across the board. Table 7 disaggregates these data by ethnicity.

**Table 6: Trade Credit, Overdrafts, Loans**

| | *% with Trade Credit* | *% with Overdrafts* | *% currently with loan* | *Applied and got Rejected* |
|---|---|---|---|---|
| Kenya | 79.2 | 62.6 | 32.7 | 5.6% |
| Uganda | 59.1 | 22.6 | 19.9 | 5.8% |
| Tanzania | 62.8 | 31.4 | 19.5 | -- |
| Senegal | 66.4 | 56.3 | 38.3 | 6.8% |
| Benin | 57.1 | 23.4 | 24.5 | |

[3] Rejection data are for current applicants only.

**Table 7: Trade Credit, Overdrafts and Loans by Ethnicity**

| | *% with Trade Credit* | | *% with Overdrafts* | | *% with Loans* | |
|---|---|---|---|---|---|---|
| | Indigenous | Minorities | Indigenous | Minorities | Indigenous | Minorities |
| Kenya | 77.4 | 79.5 | 74.2 | 61.3 | 41.9 | 31.6 |
| Uganda | 50.8 | 71.0 | 12.9 | 37.2 | 13.4 | 29.8 |
| Tanzania | 50.8 | 71.1 | 21.4 | 39.6 | 31.3 | 62.3 |
| Senegal | 63.6 | 64.9 | 49.5 | 64.5 | 32.5 | 49.3 |

Note: The ethnicity question was not asked in Zambia. For Benin, there were less than 10 non-African owned firms. The number of indigenous African firms in Kenya is very small because the sample was constrained to firms with over 10 workers.

Table 8 shows the interest rate on overdrafts and loans, the duration of loans and the collateral to loan value. We see that interest rates on overdrafts are similar to that of loans. We also see that there is a fair bit of dispersion in interest rates across countries. However, the duration of loans that firms receive is very similar across countries. The collateral to loan ratio is much higher in Kenya and Zambia, compared to other countries. Table 9 shows this data disaggregated by ethnicity of the firm owner.

**Table 8: Interest Rate, Duration of Loan and Collateral Requirements**

| | *Interest Rate on Overdrafts* | *Interest Rate on Loans* | *Average Duration of Loans* | *Collateral to Loan Percentage* |
|---|---|---|---|---|
| Kenya | 16.0 | 15.0 | 3.7 | 178.3 |
| Uganda | 17.0 | 16.7 | 3.7 | 120.7 |
| Tanzania | 12.5 | 13.0 | 3.3 | 109.7 |
| Senegal | 13.0 | 11.0 | 10.0 | 107 |
| Benin | 8.0 | 13.0 | 3.2 | 120 |

**Table 9: Interest Rate, Duration of Loan and Collateral Requirements by Ethnicity**

| | *Interest rate on overdrafts* | | *Interest rate on loans* | | *Average duration of loans* | | *Collateral to loan percentage* | |
|---|---|---|---|---|---|---|---|---|
| | Indig. | Minorities | Indig. | Minorities | Indig. | Minorities | Indig. | Minorities |
| Kenya | 19.0 | 16.0 | 16.5 | 15.0 | 3.0 | 3.0 | 150.0 | 146.5 |
| Uganda | 18.0 | 17.5 | 19.0 | 16.3 | 1.0 | 3.5 | -- | -- |
| Tanzania | 14.0 | 12.5 | 14.5 | 12.0 | -- | -- | 100.0 | 100.0 |
| Senegal | 12.0 | 11.5 | 12.0 | 10.5 | -- | -- | 100.0 | 100.0 |

All of this leads to an important question--are indigenous firms credit-constrained? This is a hotly debated topic and we are far from answering the question conclusively in this paper. But the evidence in support of the proposition is at best, mixed. It is certainly the case in our data that interest rates are high, but this does not address the question of whether firms that want to invest and grow are actually able to do so. Or whether firms

that want to end up at a certain size or sales volume are constrained by lack of finance from being able to get there.[4] This question will continue to be debated but the substantial amount of work by Francis Teal on firm survey data for Ghana seems to suggest that credit is not a binding constraint (Teal, 1998).

Our data do not present overwhelming evidence of a credit constraint. The 6 percent rejection rate on loan applications does not indicate that firms are being denied credit across the board. Table 10 presents data on the reasons why firms did not apply for a loan. The percent of firms that do not approach the banking sector varies a great deal across countries; it is as small as 16 percent in Mauritius and as high as 63 percent in Tanzania. The reasons for not applying for a loan varies across countries as well. In India, the main reason firms give is that they do not need credit. In Tanzania, many firms complain about insufficient collateral or that the interest rate is too high. In Uganda, firms do not apply for loan because the interest rate is too high and they do not want to incur debt. From these data, it is not clear that firms ar credit-constrained; but some do appear to be deterred from entering the financial market.

Tables 11 and 12 show these data broken down by ethnicity; indigenous entrepreneurs are more likely to cite insufficient collateral as a reason for not applying for a loan than minority ethnic entrepreneurs.[5] Minority firms are more likely to say that they do not need credit and a higher percentage of these firms do not apply for a loan; this is consistent with the widely held view that minority firms have their own internal networks of credit and rely less on the formal banking system. Indigenous firms are more likely to complain about the rate of interest; fewer of them state that they do not need a loan. But again, the evidence is not overwhelming that credit is the binding constraint.

**Table 10: Reasons for Not Applying for a Loan**[6]

| | *Pct not applying for loan* | *Insuff.collateral* | *Don't want to incur debt* | *Process too difficult* | *No need* | *Didn't think I'd get it* | *Interest rate too high* | *Already too indebted* |
|---|---|---|---|---|---|---|---|---|
| Kenya | 36.6 | 6.7 | 15.4 | 1.0 | 42.3 | 1.9 | 19.2 | 2.9 |
| Uganda | 58.7 | 10.2 | 20.5 | 14.8 | 18.8 | 6.2 | 17.6 | 0.6 |
| Tanzania | 63.3 | 50.0 | 27.4 | 41.0 | 28.5 | 16.1 | 61.7 | 8.0 |
| Senegal | 31.3 | 20.0 | 31.2 | 8.8 | 21.3 | 3.8 | 11.3 | 1.3 |
| Benin | 46.2 | 11.0 | 30.8 | 24.2 | -- | 1.1 | 20.9 | 3.3 |

[4] We are grateful to Francis Teal for an e-mail exchange on this subject.

[5] The data for Tanzania are not reported here because multiple responses were allowed. About the same share of firms (60 percent) in Tanzania reported that they did not apply for a loan this past year, across ethnic groups.

[6] Note: The question was not asked for Zambia and multiple answers were permitted for Tanzania and India. The answers are tabulated only for firms which answered **why** they were not applying for a loan, which is a subset of the total number of firms that did not apply for a loan.

**Table 11: Indigenous Entrepreneurs' Reasons for Not Applying for a Loan**

| | *Pct not applying for loan* | *Insuff.collateral* | *Don't want to incur debt* | *Process too difficult* | *No need* | *Didn't think I'd get it* | *Interest rate too high* | *Already too indebted* |
|---|---|---|---|---|---|---|---|---|
| Kenya | 22.0 | 3.2 | 6.4 | -- | 3.2 | -- | 9.7 | -- |
| Uganda | 65.9 | 8.4 | 12.8 | 12.3 | 7.8 | 3.3 | 13.4 | 0.6 |
| Senegal | | 20.4 | 29.6 | 13.6 | 13.6 | 6.8 | 13.6 | 2.3 |

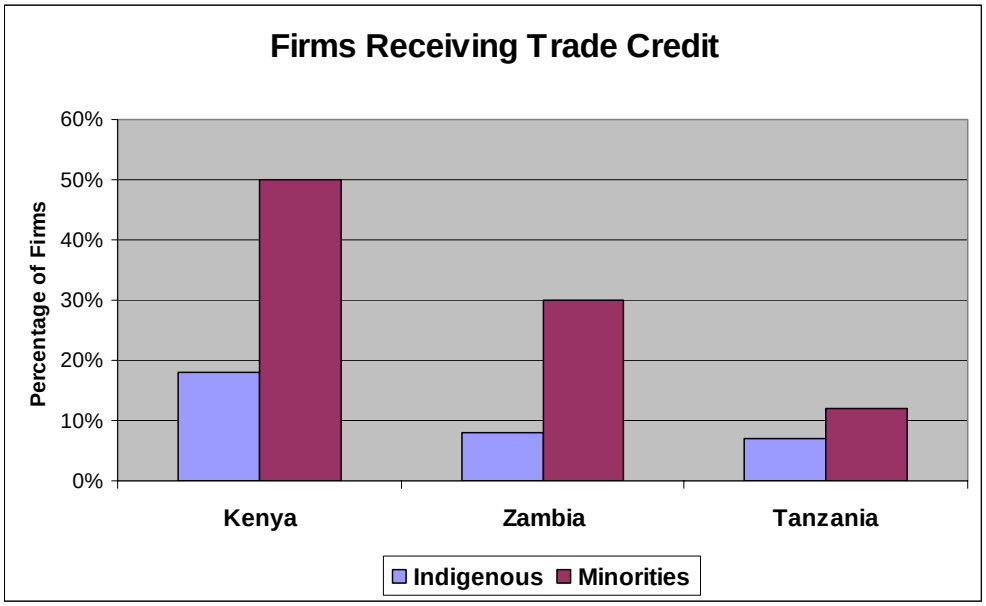
**Table 12: Minority Entrepreneurs' Reasons for Not Applying for a Loan**

| | *Pct not applying for loan* | *Insuff.collateral* | *Don't want to incur debt* | *Process too difficult* | *No need* | *Didn't think I'd get it* | *Interest rate too high* | *Already too indebted* |
|---|---|---|---|---|---|---|---|---|
| Kenya | 49.8 | 2.4 | 5.5 | 0.4 | 17.0 | 0.8 | 6.7 | 1.2 |
| Uganda | 50.5 | 2.5 | 10.7 | 3.3 | 15.7 | 4.1 | 5.8 | -- |
| Senegal | 35.5 | 13.6 | 40.9 | -- | 31.8 | -- | 13.6 | -- |

One could argue that the question on whether firms are credit-constrained remains unresolved because the data do not account for the problem of selection. One possible reason that indignenous firms do not face markedly different interest rates is that that those who did face higher interest rates or rejection rates have exited from the market or never entered in the first place. We do not observe entry and exit in our cross-sectional data and therefore cannot look at this particular question at this time; the assembly of panel data may enable us to investigate this aspect of the credit story at a future point in time.

The story on access to finance is clearer in the area of trade credit which is a component of working capital. We now turn to the question of access to credit across indigenous vs. minority ethnic entrepreneurs. Figure 7 shows that in four African countries, a larger percentage of minority-owned firms use trade credit compared to indigenous African firms.

**Figure 7: Firms Receiving Trade Credit, by Ethnicity**



Figures 8 and 9 rely on data collected in the 1990s to show that the indigenous receiving trade credit have had a much longer relationship with their suppliers than have minority-owned firms in East Africa. A detailed exploration of the issue of trade credit shows that repeated transactions are necessary to establish trade credit for indigenous firms (Biggs and Shah, 2004).[7]

**Figure 8: Average Years of Relationship with Supplier for Indigenous Firms**

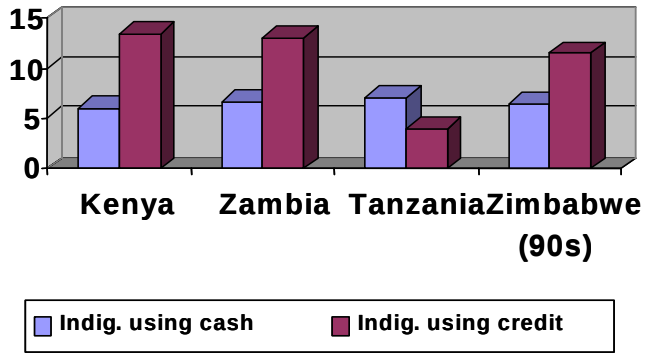
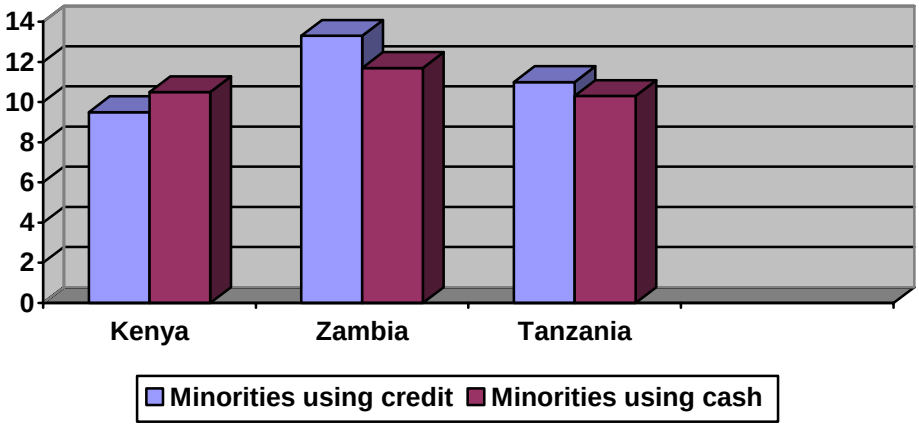



**Figure 9: Average Years of Relationship with Suppliers for Minority-Owned Firms**




It is also interesting to note that for minority-owned firms, the length of relationship with the supplier does not make much difference. There number of years dealing with suppliers has no bearing on access to credit relative to using cash for transactions, in sharp contract to the situation for indigenous firms.

Econometric analysis shows that for small and medium firms owned by minorities, the only variable affecting access to trade credit is firm size, and the magnitude of its importance is much smaller than for indigenous firms (Biggs and Shah, 2004). The authors argue that members of ethnic networks do not have to rely on establishing long-

[7] The data for Figures 10 and 11 are from the 1990s surveys conducted by the World Bank in Africa; this information is not gathered in the currrent Investment Climate Surveys.

term relationships with suppliers to get credit, as their reputation in the network provides enough information to lenders. It also indicates that even smaller firms in the business network get access to credit.

For indigenous firms, firm size is very important in determining trade credit access, as is the length of relationship with supplier. In the absence of good information on indigenous firms, suppliers use size as a proxy for information. Thus, only larger firms get credit. Smaller indigenous firms have to establish long-term relationships with each supplier to get credit. There is coordination failure in the indigenous African business community that prevents firms from developing an informal credit information system analogous to the ethnic minority business community.

The results discussed above are in large part, due to the absence of networks in the indigenous community. This leads, among other things, to a paucity of information, thereby preventing small, indigenous-owned firms from accessing capital or knowledge that would enable them to grow and prosper. This problem is compounded by the lack of enforceabilty of contracts and the weakness of the judicial system. It is not the lack of capital *per se*, but more likely the *lack of availability of information*, that is slowing the growth of the African private sector. [8]

The results presented in this paper are preliminary, based on a sample of only five countries. Further, in-depth research is needed to really understand the size and ethinc distribution of the private sector and inter-country variances in the observed patterns; new data from the Investment Climate surveys will enable us to investigate these issues in greater detail. Our preliminary analysis indicates that sub-Saharan Africa is yet to have a broad-based manufacturing sector, with indigenous firms in every size class. The constraints identified thus far show that there are some aspects of the investment climate that impact all investors, and others such as a lack of educational attainment or access to trade credit that impact smaller firms and/or indigenous entrepreneurs to a greater extent. The next section discusses the scope of some specific interventions that might address these constraints. The discussion of individual projects in this section is by no means a comprehensive summary of the interventions currently underway, but rather, is representative of critical interventions necessary to get the private sector growing in a broad-based manner.

[8] We realize that information is not the only issue that is relevant with regard to networks. It may also be the case that existing networks use their cohesiveness to engage in price-fixing or othe collusive behavior and/or be more effective at paying bribes or "getting around the system." This type of behavior will compound the problem of lack of information and put indigenous firms at an even greater advantage. If indigenous firms are able to create their own network, this may mitigate the problem by introducing competition; competing networks may reduce the ability of any single network to dominate the private sector.

## The Political Economy of Reform

We now turn to the political economy issues surrounding private sector reform. In many countries in Africa, governments have created business environments in which minority-owned firms have been able to survive and grow faster than indigenous firms. This may be a side effect of poorly-formulated and misguided policies but may also be a result of the underlying structure of incentives. The disparity between minority and indigenous entrepreneurs persists despite the millions of dollars in support programs to the private sector. Data from firm surveys done in the 1990s indicate that the problems we observe in our analysis of data gathered in the present decade have also existed in the previous one (Biggs, Shah and Srivastava, 1995).

Some scholars of Africa argue that it is convenient to have a private sector that is dominated by ethnic minorities who do not pose a significant threat to political power and often provide a steady stream of rents. Tangri argues that the minority Asian community in East Africa, which has thrived even in difficult times, often coexists with a small, wealthy, indigenous private sector, and both are closely aligned with the president or his associates (Tangri, 1999). This group relies on its political connections and its rent-sharing arrangements with the government for its survival. The government in turn relies upon it for extra-budgetary revenues. Other scholars reinforce this perspective, arguing that the political elite in Africa have found mechanisms by which to preserve rent-seeking arrangements with the sustenance of a small private sector enclave. When faced with donor-driven reforms, governments have often reacted by accomplishing partial reform, thereby satisfying the donors while preserving the arrangements of rent-seeking (van de Walle, 2001). Therefore, there has not been much change in the structure or competitiveness of the private sector; reforms have often increased the levels of uncertainty for the business community more than anything else.

In his analysis of the political economy of reform, James Emery notes that the "overall complexity places a premium on means of circumventing, or speeding up the process, which creates a flourishing environment for corruption." Emery argues that most businesses in Africa are operating outside the law in at least one or more aspects and are vulnerable to government inspectors, no matter how minor the deviance. The survival of a business is consequently heavily dependent on a personal relationship with a minister or other high government official, which is often difficult to document or quantify. These relationships are crucial to firms that need to anticipate *ad hoc* policy or regulatory changes—a major concern of business as shown in the investment climate surveys. Emery concludes that "this vulnerability, combined with the arbitrary nature of enforcement arising from poor governance means that firms can be closed down or worse for operating in exactly the same way as their neighbors, their competitors, or their clients and suppliers" (Emery, 2003).

Following Emery's analysis, one has to consider the difficult problem of dismantling some of the key control points that some governments continue to maintain, which are used to penalize firms which represent a political threat. While the situation on the ground is changing and sometimes quite quickly, what governments still seem to fear the

most is a private sector which generates wealth independent of government controls, and which makes its own, unfettered, decisions.

It is worth pointing out that in some cases, the unease on the part of government officials exists on purely economic grounds, arising from very real concerns about protectionism in developed country markets, lack of domestic demand, and the ad hoc changes in donor priorities. In other cases, it is the uncertainty that arises from lack of control over the generation of wealth, particularly where the private sector is dominated by a few players. Despite decades of donor advice, it is still relatively difficult to find policymakers who really trust markets to deliver results; given the choice, a regulatory or administrative solution is often preferred. One example is the current discussion on competition policy, which some policymakers interpret to mean justifying interventions to make up for lack of competition, not measures to increase competition itself, as this prevents their ability to decide who the winners are.[9] Another disincentive to reduce controls arises from the fact that a more competitive playing field might result in higly visible gains by business owners from ethnic minority groups. This in turn makes it easier for opponents and the press to attack government leaders responsible for their "open competition" policies.[10]

The key question that arises from these concerns is—how can governments be convinced that a broad-based, relatively unfettered private sector is in their interest? And that drastic measures to curb the rights of minority entrepreneurs will not result in viable opportunities for indigenous entrepreneurs? Available evidence on the private sector shows for that for the most part, reforms to promote private sector development have led, atleast in the early stages, to a proliferation of small and medium firms in countries such as Taiwan, Malaysia etc. These firms are hardly a challenge to political power; in fact, they are probably less likely to lead to political problems than the current system in which governments foster the rise of a small, wealthy class of tycoons and/or the continued dominance of a minority ethnic group. Another way to address government unease is to chip away at the edges, focusing on reforms that are less politically difficult and which pave the way for future, bigger efforts. Whatever the path, it is overwhelmingly clear that we need to focus on building political will towards private sector reform, rather than on technical solutions alone.

On a more positive note, it is important to note that things are changing with the emergence of democratic governments and stronger institutions in several African countries. One promising example of reform within Africa is Senegal which has significantly lower costs of doing business relative to other countries in the region (Eifert, Gelb and Ramachandran, 2005). The Senegalese case needs to be explored in further detail, with a focus on understanding the political incentives for reform and the process of

[9] One example is the Commercial Bank of Ghana, which has been pledged to be privatized no less than three times as part of IDA credit operations in the past 15 years, but this is yet to be accomplished.

[10] Ongoing research suggests that the lobbying behavior of firms reflects the overall state of business-government relations in sub-Saharan Africa (Ramachandran, Shah, and Tata, 2007, forthcoming). African firms lobby politicians in order to maintain market share, in contrast to lobbying behavior in Asia where market share is not a significant determinant of lobbying behavior.

implementation. Even in East Africa, where ethnic minorities have dominated the private sector for a long time, anecdotal evidence suggests that more indigenous entrepreneurs are entering the private sector and are running very profitable businesses.

The most recent *Doing Business* report from the World Bank highlights several countries in Africa that have reformed their regulatory regimes and lowered the time and cost to register a business (Doing Business, 2007); again, it would be useful to understand the political dynamic behind these efforts. Finally, we cannot underestimate the power of individual efforts—one example is that of Justice James Ogoola, who has championed a highly effective commercial court structure in Uganda, which relies on pushing routine disputes into mediation and getting settlements in a matter of days, rather than months or years. Individual entrepreneurs are playing a role in shaping their country's policies and in so doing, are also changing attitudes towards entrepreneurial activity.

Can Africa learn from India's experience with private sector reforms? This is a question that one often hears, given India's past policies of protection and its current visibility and rising success. While there is no doubt that India's reform processes have a long way to go (and are sometimes overrated), there are likely some lessons, particularly on the political economy front. How did India reduce the regulatory burden on the private sector? What are the underlying forces that have transformed, and are continuing to transform, political will and attitudes toward the private sector? While it is beyond the scope of this paper to go into detail on this topic, the emerging literature on India's reforms point to three things—the demonstration effect of India's success in the high-tech sector, the emergence of "MBA politicians" who are focused on improving the productivity of the private sector, and the realization that public revenues generated from higher rates of economic growth may well be more beneficial than fluctuating rents. It is well within the capabilities of several countries in Africa to replicate some features of the Indian success story--call centers, back-office processing firms in Ghana and South Africa, and high tech firms in Madagascar and Mauritius are all emerging as strong competitors in the international arena. These and other firms will need the support of their governments and a business environment that will provide a reliable supply of power and water and a transparent system of taxation and regulation.

## Building Networks

Our analysis indicates that the "network effect" within minority ethnic groups may be significant. This may be the case because information flows and contract enforceability are weak in much of sub-Saharan Africa. Minority entrepreneurs within a network have a much greater incentive to stick to their contractual boundaries as members of the network will enforce contracts and/or inflict penalties for violations. Indigenous entrepreneurs who are not operating within a network are not bound by these types of enforcement mechanisms nor are they able to generate enough credible information to enable them to access trade credit or other resources. Also, members of the network have detailed knowledge of each others firms and of the characteristics of the managers; this enables a positive flow of credit, technology and other resources, on terms that are unavailable to firms outside th network.

Rather than penalizing ethnic minority groups to promote indigenous entrepreneurs (as some populist governments have done in the past, with disastrous results), efforts must be made to improve information flows and/or create alternative, competing networks. Our data show that university education is significant in determining the performance and rate of growth of indigenous firms. This result may reflect entry into a network of business professionals that serves as an alternative to ethnic minority networks. It may include enabling the flow of information—about firm performance, characteristics of the entrepreneur and other vital data that enable lending, the supply of trade credit and the transfer of technological knowhow. If this is the case, it points to the need for more business education, whether it be in the form of formal business schools or vocational training which is directly related to firm-specific skill formation. It might also be in the form of more informal skill-building workshops or entrepreneurial "boot camps."

A partnership between the World Bank's Micro, Small, and Medium Enterprise Project (MSME) and the International Finance Corporation's Global Business School Network (GBSN) to improve the quality of business education began in early 2004 with a project in Kenya; the partnership has since grown to projects in four East African countries. The project in Kenya is supporting a case writing program to three universities with a particular focus on the needs of MSMEs. This project will develop the capacity to create and use cases for the training of business students and small firms in East Africa. GBSN is also working with the Faculty of Business and Economics (FBE) at Addis Ababa University in Ethiopia to design solutions relevant to their business environment. GBSN has linked local faculty with international mentors to upgrade curriculum, while enhancing the transfer of skills to additional institutions. This business school in Addis is the only graduate-level business school in the country and has a huge demand for it's programs. GBSN is also working with the Faculty of Commerce and Management at University of Dar-Es-Salam in Tanzania to ensure a sustainable supply of quality managers. The government of Rwanda has requested the World Bank and IFC to help the nation's only business school develop so as to increase the local supply of human capital for private sector development.

While the emphasis of the GBSN effort is on the quality of education (as it should be), we believe that this activity is attracting high quality students who will constitute an important network of business professionals upon graduation. This network will provide competition to existing networks, build trust between its members, improve information flows between its members, and enable the enforcement of contracts.

The supply of information and the enforceability of contracts can also be improved by the strengthening of the legal and contractual environment. Recently, the International Finance Corporation (IFC), with the support of the Swiss government's State Secretariat for Economic Affairs (SECO), has announced an innovative project in Tanzania that will help firms to acquire finance for the leasing of equipment. According to the IFC brochure, IFC has helped leasing development in 40 countries and has invested $1 billion in the leasing sector 50 countries in the last three decades. The Swiss government has been successful in its own leasing program for small and medium sized firms, with regard to road projects in Tanzania.

Rather than simply focusing on increasing the supply of money to firms, the IFC-Tanzania project aims to reform legal, tax and accounting procedures to attract investment into the leasing sector. Targeting firms that have not been able to attract bank financing, including firms that do not have the necessary credit history, IFC argues that leasing of equipment will help firms, particular small and medium-sized firms, to grow in a sustainable manner. It also argues that leasing does not require large outlays from firms; leasing companies usually require an advance of 10 to 30 percent of the equipment's cost from the lessee. The ability of the lessee to generate adequate cash flow to pay for equipment rentals is usually higher than its ability to purchase the equipment outright. Finally, there is often no need for collateral or security, identified in our analysis as a significant constraint, particularly when no information about the firm is available. Overall, the terms of this type of leasing are very favorable to smaller, indigenous firms, such as those identified in this analysis.

The IFC project is innovative in that it addresses the leasing issue *comprehensively*—most critically, IFC is working on creating favorable legal and economic conditions for leasing development in Tanzania. The project has six critical components—a legislative review that will look at current and proposed leasing legislation, capacity building to train potential lessors, lessees and other stakeholders, business development to bring together SMEs, equipment manufacturers and others, public education to publicize the leasing option to the business community, micro-leasing to enable even the smallest firms to access this type of finance, and finally, the formation of a leasing association. The IFC-Tanzania leasing project has the potential to be replicated elsewhere in sub-Saharan Africa, addressing the critical needs of small firms by enabling them to build a reputation, and by increasing the supply of information about these firms.

Finally, improving the level of subcontracting between large and small firms may be very useful to the learning process. Subcontracting is often mentioned as a possible path to the creation of a larger, more densely populated privates sector. One successful attempt at doing this is the Swiss Development Corporations' Road Sector Support Programme in

Tanzania, which has focused on increasing the supply of information to create linkages between firms. Another promising effort is the World Bank's Growth Poles project, being implemented in Madagascar. Among other things, this project was designed with the specific aim of increasing linkages between large and small firms.

There are, of course, several other areas highlighted by the investment climate survey data that are in need of governments' attention—in particular, the creation or restructuring of rules surrounding ownership of land, the reform of judicial, customs and tax authorities, in order to provide timely and transparent services. It is not the case that there must simply be "less government," but rather that governments must be persuaded that a broad-based private sector is in their interest. In some countries in Africa, this type of government is emerging and showing strong results; it is crucial that the donor community identifies and nurtures these reform efforts.

And finally, is there enough money to facilitate reform? This is the subject of unending debate, but it is worth noting that private sector reform does appear to be at the top of the list of both government and donor priorities in many countries in Africa (*Doing Business*, 2007). The newly established Investment Climate Facility is a significant attempt to put the private sector at the center of Africa's growth agenda; its ability to identify and fund worthy projects will be tested in the coming years (Moss and Rose, 2006).

In order to alleviate the poverty of millions of people living in sub-Saharan Africa, we have no choice but to focus on how to bring the vast majority of Africans into the realm of the private sector activity. A continuous stream of accurate data that reveals the specific constraints facing firms in the African private sector is vital to this effort, as is the will to carry out much-needed reforms.

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