



Research for Development

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ABOUT ACEG

African Centre for Economic Growth (ACEG) started its operations in 1993 as Africa regional office of the International Center for Economic Growth (ICEG) and was registered in Kenya in 1999 as a non-profit, non-partisan autonomous policy research organisation.

The mission of ACEG is to increase knowledge of the policies that work to accelerate economic growth and expand income opportunities for the people of Africa.

ABOUT THIS POLICY BULLETIN

This Policy Bulletin provides a channel through which to disseminate the results of research on policy issues affecting economic growth and development in Africa.

The objectives of the Policy Bulletin are to:

- disseminate research findings to key stakeholders in an effort to promote consensus on policies for sustaining economic growth and human development in Africa;
- provide informed policy advice to policymakers, intermediary organisations, civic and opinion leaders in order to promote sound management of the development process in Africa.

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GROWTH & TRANSFORMATION OF SMALL FIRMS IN AFRICA INSIGHTS FROM GHANA, KENYA AND ZIMBABWE

Micro and small-scale enterprises have many attractions: they serve as breeding grounds for large firms, provide entry points and training for new entrepreneurs, link closely with agriculture and serve as laboratories for the development of low cost products. They are also more labour-intensive and hence more efficient in the context of capital scarcity than large-scale enterprises. These enterprises promote distribution of income not only on account of their labour intensity but also because they are often owned by the poor. Unfortunately, research has shown that micro and small-scale enterprises suffer high mortality rates, remain informal and subservient, and rarely grow or graduate to higher size thresholds. This state of affairs poses a major policy and development challenge.

To shed light on the dynamics of small firms in Africa, the African Centre for Economic Growth commissioned a multi-country study utilising funds availed by United States Agency for International Development (USAID). The study was carried out by ACEG partner institutes in Ghana, Kenya and Zimbabwe. In Ghana, the research activities were co-ordinated by the Economic Policy Management Programme in the Economics Department of the University of Ghana. The Institute of Policy Analysis and Research in Nairobi and the Southern Africa Microfinance Capacity Building Facility in Harare co-ordinated research activities in Kenya and Zimbabwe respectively.

The multi-country study sought to (a) establish the most appropriate basis for firm size categorisation (b) determine the size distribution of small firms and main features of each size category (c) identify key factors influencing the growth and transformation of micro and small-scale manufacturing firms and (d) explore the pattern of firm growth and transformation and (e) indicate ways through which small firms can contribute to and enhance Africa's rapid growth agenda. Combining a common questionnaire and country-specific cases studies, data were collected and analysed on the three countries involved: Ghana, Kenya and Zimbabwe.

The analyses showed that size distribution of micro and small-scale manufacturing firms in Africa is skewed to the left and dominated by single-person operations. The growth, graduation and transformation, of these firms were also confirmed. These firms dynamics are shaped by entrepreneur and enterprise-specific attributes, of which an owner's technical skills and experience and the firm's age and formalization status are key. Policies that facilitate the registration of firms increase their life expectancy and permit faster acquisition of technical skills; they therefore have value in promoting progressive micro and small-scale manufacturing firm dynamics and general industrial transformation in Africa. Still, additional information on the productivity consequences of different firm dynamics, appropriate measures for assessing

the depth of the transformation of firms, and unpacking of the latent variables that have a comparative bearing on firm dynamics such as gender, race and location is necessary.

Reasons for conducting the study

Africa needs to be put on a rapid growth path to push large numbers of unemployed Africans towards productive employment, reduce large-scale poverty and improve lives of masses of Africans. The strategy for such rapid growth has to include the transformation of micro and small-scale enterprises so that they can exploit scale economies, shift businesses to thresholds of greater value addition and allow technological adaptations. Unless these firms can grow and transform, they will not adopt to efficient production technologies and contribute to the rapid transformation needed in Africa.

Very little is known about the life cycle dynamics of micro and small-scale enterprises in Africa. Do they ever experience growth and growth spurts, and in what size categories and time period do these firm dynamics manifest themselves? How can firm growth be activated and consolidated once it sets in? What triggers small firm transformations and what are some key manifestations of the triggers? Why do some firms stagnate while others do not upgrade their technical capability? What precipitates changes in management styles? What ownership and managerial characteristics contribute to these transformations? These research questions provided the motivation for the study.

How the research was conducted

This policy brief draws from a synthesis of country reports for Ghana, Kenya, and Zimbabwe. The three countries were selected because small and micro scale sectors in each of them had been previously surveyed. Micro and small scale firms in these countries have also been burgeoning in recent years. The finalisation of the study proposal and identification of study teams led to a methodology workshop that mapped out a strategy for project implementation. The manufacturing sector was selected in order to control for heterogeneity across activities and increase the likelihood of picking meaningful dynamics.

A common research instrument was applied in the three countries. Stratified sampling design was used to identify firms for the survey. The survey covered food processing, wood-working, textile and garments, and metal-working firms, which account for the lion's share of manufacturing activities in Africa.

Structured questionnaires were administered in the first incidence to generate information on the histories of firms

and entrepreneurs, employment trends, sales, management systems, assets, investment, firm level technology capabilities, and perception on government policies and the quality of public services. Extensive use was made of descriptive analysis. Quantitative analysis was used to complement qualitative analysis in exploring behavioural relationships embodied in firm dynamics. For this second level of analysis, a selection of explanatory variables was restricted to variables relating to initial conditions to obviate statistical pathologies such as endogeneity.

Case studies permitted a deeper follow-up on issues pertaining to small firm growth and transformation, and thus reduced the need for detailed longitudinal data. Part of the incentive for the inclusion of case study information was recognition that the growth and transformation of small firms is the outcome of a complicity of factors that interact in ways that may be lost in the analysis of broad survey data.

Conceptually, positive transformation occurs when firms shift from a poor institutional threshold to a more progressive one so that from then on they become subject to different rules of the game. The transformational outcomes may be simple or complex. Consider for example what happens when a firm that was operating informally is registered with a registrar of companies. This single, apparently pedestrian, event exposes the firm to different operational rules. This is because the registration not only reduces official harassment but also improves the legal status of the firm. In the process, the firm has better access to public services and external markets. Of course, registration makes the firm subject to state regulations such as licensing, labour laws, health regulations and tax assessments that in turn expose it to bureaucratic red tape and corruption. For firms initially operating unregistered, registration fundamentally changes the rules of the game that henceforth shape the firm's operations and growth prospects.

Research findings

Size distribution

The size distribution of small manufacturing firms in Africa is skewed to the left, confirming other findings that have demonstrated that the size distribution of industrial firms tends to have many small firms and few large ones. This distribution is an outcome of two diametrically opposite processes relating to scarcity of local capital that forces indigenous firms to start small and grow horizontally and foreign direct investments and capital intensive technologies that allow some firms, usually foreign, to start large and remain so. This distribution partly accounts for the missing middle phenomenon common during early industrialisation.

In terms of ownership structure, there is evidence of dualism in African manufacturing: indigenous entrepreneurs typically own small firms while their minority European and Asian counterparts own medium-sized and large firms. As a result, industrial sectors in many African countries are dualistic with a very large number of minute firms, a small number of large firms, but very few medium-sized firms. The visible absence of middle-sized firms arises from regulatory, enforcement and transaction costs that are higher for medium-sized than for small and large firms.

One-worker firms that dominate early stages of industrialisation are evident in Africa. These are self-employment activities often operated informally by poorly educated, African female proprietors. Two worker operations are also common. These usually include a mixture of unpaid family and paid workers in their labour force. Beyond two workers, operations tend to become formalised, and management structures change to paid managers. Where this does not happen, a binding management bottleneck begins to manifest. Human capital attributes such as education, race and gender that in turn determine an entrepreneurs' ability to tap on to financial and managerial resources ultimately determine the size of a firm

Graduation

Small manufacturing firms in Africa graduate from one size category to another during their lifetimes. In the process, a significant proportion of firms that start very small graduates to higher size categories. A cross-country comparison shows greater incidence of graduating in Ghana, perhaps in response to better macroeconomic out turns in recent years relative to Kenya and Zimbabwe. Further, founders of firms seem better able to nurture their enterprises into graduation than secondary owners who acquire businesses through either inheritance or purchase. At the same time, female-owned firms perform relatively badly with respect to graduation as do African-owned firms relative to those owned by persons of other races. Proprietors' gender and race therefore influence the graduation prospects. The graduation is not lifecycle in nature, since young firms are just as likely to graduate as old ones. Management arrangements also count, with the owner-manager management mode common among small manufacturers seemingly undermining the graduation process. Formalization of firms, however, seems to tip the balance in the direction of graduation.

Growth and growth spurts

Africa's small manufacturing firms not only graduate but also systematically grow and experience growth spurts.

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The odds for and the rate of such growth and its spurts vary with firm age and size, registration status, business heritage, location, gender, age and, to some extent, the race of the proprietor. An assortment of other firm and proprietor attributes shape growth and its spurts, too. On these accounts, it can be concluded that micro and small scale enterprises in Africa do grow as some literature asserts.

Firms owned by persons with vocational skills and business experience gained from years of exposure to similar enterprises—indicating that the owners understand different aspects of a business, production processes and markets before start-up—should generally show greater inclination to grow. Ultimately, the growth of a firm results from a deep knowledge of markets of interest to the firm, as evidenced by relationships between entrepreneurs and key market players. Firms also grow when their owners/managers value expansion, seize opportunities and overcome growth obstacles. When growth is not perceived as beneficial and barriers are un-surmountable, firms tend to stagnate. This study demonstrates the importance of registration as a lever for firm growth and growth spurts and shows that while growth spurts take place over time and are therefore lifecycle, young and small firms are generally more likely to grow and enjoy faster growth rates than old ones.

Transformation

Small manufacturing firms in Africa transform, so that they move from one to another institutional threshold. Nevertheless, these firms neither share uniform transformations nor are the depths of the transformations symmetric across countries. Some entrepreneur-specific and firm-specific factors shape the structure and depth of such transformation of firms. In respect to firm-specific factors, the age of a firm increases odds for the transformation of firms in the three countries, so that increasing the life expectancy of small manufacturing firms probably holds a key for industrial transformation in Africa. On a different tangent, while general education seems worthless from the viewpoint of firm transformation, technical skills drive firm transformation as does experience gained through either operating similar activities or working for firms in the same line of business.

Policy directions

Paying attention to local peculiarities, and considering the importance of formalization of firms in the growth and transformation process, registration of businesses could be made easier by increasing access by very small firms to registrars of companies and reducing exposure to registration-related red tape. Given the low levels of literacy, part of the simplification of registration can be achieved by making the language of registration as local

as possible. Reduction in registration-related costs will encourage small manufacturing firms to move away from informality and release micro firms that dominate the small manufacturing sector from the stranglehold of informality, giving them an opportunity to exploit their full potential and optimise contribution to development. One aspect of informality is failure to keep records of accounts. This failure is particularly evident in the micro scale manufacturing firms, many of which depend on mental retention of information on their performance and often confuse revenues with profits. In the interest of the growth and transformation of these firms, educational and training programmes that underscore the importance of businesses records in planning and tracking firm level performance are needed. The programmes would specifically target the smallest of the small manufacturing firms that appear less inclined to keep books of accounts.

In an endeavour to increase the life expectancy of micro and small-scale manufacturing firms; policies should be designed to reduce non-commercial risks through improvement of opportunities for effective conflict resolution and enforcement of business contracts. This will unleash the graduation, growth and transformation potential by promoting continuity and increasing the life expectancy of small manufacturing firms. Baby firms that dominate the very small segment of Africa's small manufacturing sector and that often fail to survive the formative years should be specific objects of such a policy. All this is necessary because the analysis has shown that firms often need to live long enough so as to eventually get an opportunity to grow, graduate and respond to changing market trends by transforming. In an environment where life expectancy is short, such as that in which many of micro and small manufacturing firms Africa operate, these firms miss the opportunity to benefit from lifecycle dynamics.

There is need to form links between resources/agricultural activities and manufacturing to further exploit the growth spurt potential of the wood and food processing sectors. Improvements in the general rural-urban communication, particularly in rural access roads, are important steps in that direction. This policy is desirable because the study shows that sectors drawing manufacturing feed-stock from Africa's natural resource base show significant growth, graduation and transformation potential.

More educational institutions are desirable in expanding the pool of educated persons from which the business sector draws, but the development of Africa's human capital should tilt towards building skills appropriate for

the business world. This is because Africa's formal school curricula do not prepare students for business as formal education performs poorly on firm growth and transformation. However, technical skills are supportive of such growth and transformation.

Outstanding research problems

The transformation of firms is multi-dimensional; consequently, additional information is needed on the productivity and firm performance consequences of different aspects of the transformation. It is important to know, for example, whether upgrading productive equipment and moving from owner-management to paid-management generate similar productivity outcomes, or whether there is an implied pecking order that defines progression along the enterprise transformation path. Such information is needed to sharpen the targeting of policies aimed at the promotion of enterprises. Overall, the additional analysis will be useful in improving the index for measuring the depth of transformation by suggesting a refinement of the weighting of its different dimensions.

Africa's industrial property markets are such that manufacturers, whatever their size, eventually gravitate towards location in own premises, thereby incurring heavy sunk costs. The sunk costs make firms more obtrusive and less footloose, undermining their ability to short circuit unfriendly social infrastructure such as red tape and corruption. Further research is needed to explore the structure of industrial property markets as a guide to formulating policies that reduce the stranglehold of sunk costs in a bid to promote further growth and transformation of firms.

We do not know enough about what seemingly latent variables such as gender, race and location represent in the context of micro and small-scale manufacturing in Africa. Further research is needed to sustain the unpacking of these composite variables as part of the process of increasing the stock of knowledge on firm dynamics.

There are also methodological difficulties in using cross-sectional survey data to track firm dynamics best understood when it is possible to follow firms through the entirety of their lifecycles. This is not possible in the absence of longitudinal information that can only be generated by observing the same firms over along periods of time. Research on micro and small-scale manufacturing firms in Africa should begin to move in that direction for a better understanding of the structure of the dynamics that shapes the lifecycle of such firms &

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