

# Determinants of Growth and Diversification of Micro and Small Enterprises: The Case of Dire Dawa, Ethiopia

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## ABSTRACT

This research was aimed at identifying factors affecting growth and diversification of micro and small enterprises with a special emphasis on construction, manufacturing, and service sectors in Dire Dawa Administration. The study used a stratified random sampling method to select 190 micro and small enterprises. To achieve the objectives of this study, data were collected using questionnaire through face-to-face interview and observation, and analyzed using descriptive and inferential analyses as well as econometric models. The descriptive result showed that the source of finance at the start-up were mainly personal saving and the major constraints of the enterprise engaged in construction, manufacturing, and service at this time were lack of sufficient capital, marketing and working place. The next major problems which affected the growth and diversifications of the three sectors in the study areas were right advices, opportunities, technology, and legalization. Majority of the respondents of construction and manufacturing agree with opportunities and technological problems. But, respondents of the three sectors agreed with the right advice and legalization problems. The average start-up capital of enterprise engaged in construction, manufacturing, and service was Birr 6909.47 with an average of 6.48 employees and at the time of the study, the average employment was 7.23 employees. About 85.8% of survey respondents sold their products/services in the local market and 14.2% of them sold their products/services external market inside the country. However, no firms were participating in export markets. The econometrics result indicated that age of owners/managers and enterprises engaged in construction were negatively related to growth of enterprises. Previous work experience, enterprise engaged in manufacturing, access to market, access to working and selling premises, amount of initial capital, access to finance, social networks, and vertical linkage were important factors which affected the growth of MSEs positively. Similarly, diversification of MSEs was positively influenced by opportunities, information and communication technology, strengthening the household asset basis, and availability of key assets. Genders and age of owners/managers were also found to be significant factor which affect diversification of MSEs negatively. The findings of the study verified the importance of micro and small enterprises in employment creation. The Dire Dawa Administrative city has to promote the growth and diversification of micro and small enterprises by facilitating necessary credit services, working premises, market, and experience sharing to update their knowledge. In this regard, creation of awareness of the owners/managers to follow a related diversification strategy through using opportunities, ICT and key assets that are underutilized within the enterprises. And also it is advisable to give special attention and support for enterprises that are owned/managed by female.

**Key words:** Micro and small enterprises, Employment growth, Related diversification

## 1. Introduction

### 1.1. Background of the Study

Micro and small enterprises (MSEs) are believed to have a vital role in poverty reduction, employment generation as well as economic development in poor countries like Ethiopia. The Ethiopian MSEs sector includes a diverse set of operators ranging from petty traders to small restaurant owners; shoeshine boys to small shoe making enterprises; peddler in the streets to grocery business operators, etc. Micro enterprises are the smallest, informally organized business activities while small enterprises are rather formal businesses that fall under purview of the country's legal and regulatory system.

According to the MWUD (2007), MSEs sector is believed to be the major source of employment and income generation for a wider group of the society. The major objective of MSEs development program, which is creating and promoting MSEs in urban areas, envisages reducing urban unemployment rate.

In most fast developing countries, MSEs by virtue of their size, location, capital investment and their capacity to generate greater employment have proved their powerful propellant effect for rapid economic growth. The sector is also known as an instrument in bringing about economic transition by effectively using the skill and talent of the people without requesting high-level training, much capital and sophisticated technology. The MSE sector is also described as the national home of entrepreneurship. It provides the ideal environment enabling entrepreneurs to exercise their talents to the full and to attain their goals. In all the successful economies, MSEs are seen as an essential springboard for growth, job creation and social progress at large.

The MSE sector is characterized by highly diversified activities which can create employment opportunities for a substantial segment of the population. This implies that the sector is a quick remedy for unemployment and poverty problem. The realization of a modest standard of living through curbing unemployment and facilitating the environment for new job seekers and self-employment requires a direct intervention and support of the government and other concerned stakeholders (Mulugeta 2011).

### 1.2. Statement of the problem

MSEs in Ethiopia are expected to play a significant role for national growth and development as well as minimize unemployment and related social problems. In Dire Dawa, the sector has stagnated and remains relatively small in terms of its contribution to economy or to gainful employment. According to Dire Dawa Administration MSEs Development Agency, there are 374 MSEs, which created job only to 5116 people. This indicates that the role of the MSEs in the city regarding job creation and economic development is very insignificant. There are large numbers of small scale enterprises in the city. However, the city has not yet exploited their potential very well to contribute for economic development, job creation and poverty reduction of the city and the country as a whole.

### 1.3 Objectives of the study

The general objective of this study was to examine determinants of growth and diversification of MSEs in Dire Dawa Administration. The specific objectives of the study were:

- To assess the structure of growth and diversification.
- To identify factors affecting growth of MSEs; and
- To identify factors affecting diversification of MSEs.

## 2. Research methodology

### 2.1. Data Sources and methods of Data collection

The study used both primary and secondary sources of data. Structured questionnaire was prepared and used to collect data from all relevant sectors of MSEs in Dire Dawa. Face-to-face interviews were carried out with the MSEs operators and/or the relevant owner managers in the selected sectors and important government officers. Observation and informal discussions were also used as additional information. Variety of books, published and unpublished government documents, websites, reports and newsletters were reviewed to make the study fruitful. Moreover, relevant literature and other documentations supporting the objectives of study were reviewed.

### 2.2. Sampling Method and Sample Size

#### 2.2.1. Sampling method

Stratified random sampling method was used for the study. The strata were the sectors (i.e. construction, manufacturing and service). The distribution of sample taken from different sectors is as follows (Table 1).

Table 1. Sample distribution

Sector	Number of Enterprises	Females	Males	Total	Sample
Construction	273	680	3019	3699	142
Manufacturing	66	168	614	782	34
Service	28	302	212	514	14
Total	367	1150	3845	4995	190

Source: Own design based on Dire Dawa Administration MSEs Development Agency (2012)

### 2.2.2. Sample size determination

There are several approaches to determine the sample size. These include using a census for small populations, imitating a sample size of similar studies, using published tables, and applying formulas to calculate a sample size. This study applied a simplified formula provided by (Yamane 1967) to determine the required sample size at 95% confidence level, degree of variability= 0.5 and level of precision =5%.

$$n=N1+N(e)^2 \quad (1)$$

Where n is the sample size, N is the population size (equal to 367) and e is the level of precision (equal to 5%). The above formula required a minimum of 191 respondents and this study was carried out on 190 respondents. A total of 190 MSEs (142 from construction, 34 from manufacturing and 14 from service sectors) were randomly selected based on probability proportional to size.

## 2.3. Methods of Data Analysis

### 2.3.1. Descriptive and inferential statistics

Both qualitative and quantitative techniques were used to analyze the data. The qualitative data obtained from key informant interviews and personal observations were analyzed through description and narratives using words. The quantitative data on the other hand were analyzed by using descriptive and inferential statistics such as percentages, frequencies, mean, variance, standard deviation, chi-square tests, F-test, and T-test.

### 2.3.2. Method of analyzing growth

The CAGR is preferred than average growth rates or number of changes in employment since start up in several studies of employment growth. The use of compound annual growth rates permits a much more precise assessment of the timing of employment growth effects Liedholm & Mead (1999). In the same way the analysis of employment growth of MSEs in this study was done using CAGR.

#### 2.3.2.1. Econometric models

In the studies of firm growth, researchers often use three kinds of econometric models to estimate significant factors for growth, such as multinomial Logit models, Logistic or probit regression models and multiple linear regression models. In multiple linear regression models, the dependent variable is explained by means of a set of independent variables. In this analysis, a multiple linear regression analysis was used to test whether or not the key independent variables were related to the dependent variable. The multiple linear regression analysis was chosen because growth measure, annual compound growth of MSEs, used as the dependent variable takes a continuous measure.

For the analysis of the growth of MSEs in Dire Dawa, the multiple linear regression models that were used to estimate are formulated as follows:

Growth in employment = f (Manager/owner age, Manager/owner gender, Manager/owner education, Previous work experience, Right advice, Sector type, Access to market, Own premises, Access to finance, Amount of initial capital, Access to infrastructures, Social networks, Vertical linkages, Horizontal linkages, and Supporting markets).

The general multiple linear regression models is specified as:

$$\ln(((CE/IE)^{1/EA})-1)=\alpha_0+\alpha_1\ln(AGE)+\alpha_2\ln EDU+\alpha_3\ln(I-CAP)+\ln\sum\beta_iX_i+\ln\epsilon m_i=1 \quad (2)$$

Where

$\ln(((CE/IE)^{1/EA})-1)$ = the logarithm of compound annual growth rate

$\alpha_0$ = the intercept term

$\alpha_i$ = the coefficient of logarithm of manager age, initial capital and education

$\beta_i$  = the coefficient of  $X_i$

$\ln(\text{AGE})=\ln(\text{EDU})=\ln(\text{I-CAP})=\ln(X_i)$ = the logarithm of explanatory variables

$\ln(\varepsilon)$ =logarithm of the error term

$m$ = number of explanatory variables

### 2.3.2.2. Multicollinearity test

As we are producing multiple regression models, we need to be aware of certain features of the multicollinearity. That means, when two or more independent variables are highly correlated with each other this is known as multicollinearity. The existence of multicollinearity might cause the estimated regression coefficients to have the wrong signs and smaller t-ratios that might lead to wrong conclusions.

There are two measures that are often suggested to test the presence of multicollinearity. These are: Variance Inflation Factor (VIF) for association among the continuous explanatory variables and contingency coefficients for independent variables. The technique of variance inflation factor (VIF) was employed to detect the problem of multicollinearity among the continuous variables. According to Gujarati (2003), VIF can be defined as:

$$\text{VIF}(x_i) = \frac{1}{1-R^2} \quad (3)$$

Where,  $R^2$  is the square of multiple correlation coefficients that results when one explanatory variable ( $x_i$ ) is regressed against all other explanatory variables. The larger the value of  $\text{VIF}_i$  the more “troublesome” or collinear the variable  $X_i$  is. As a rule of thumb, if the VIF of a variable exceeds 10, there is a multicollinearity problem.

Similarly, contingency coefficients were computed to check the existence of multicollinearity problem among the independent variables. The contingency coefficient is computed

$$C = \frac{\sqrt{\chi^2}}{\sqrt{N+\chi^2}} \quad (4)$$

Where, C= Coefficient of contingency

$\chi^2$  = Chi-square random variable and

N = total sample size.

The decision rule for contingency coefficients is that when its value approaches 1, there is a problem of association between the independent variables (Perry *et al.* 2004).

### 2.3.2.3. Explanatory variables of multiple regression models

Review of literature on factors influencing growth of MSEs, past research findings and the researcher’s knowledge of the MSEs of the study area were used to establish analysis of this study. In other words, among a number of factors, which have been related to growth of MSEs, in this study, the following individual entrepreneur characteristics, firm characteristics, social networks, inter-firm cooperation, and supporting market were factors hypothesized to explain the dependent variable (growth in employment).

#### Individual Entrepreneur Characteristics

We now discuss individual entrepreneur characteristics for which there is significant empirical evidence from developing countries: manager or owner age, education, previous work experience, gender, and right advice. Numerous growth factors examined in the developed country literature are understudied in developing countries. Entrepreneurs or managers with higher formal education, work experience and training would therefore be expected to grow faster. The firm grows if successful, closes if unsuccessful (Goedhuys & Hardi 2002).

**Manager/Owner age (AGE):** The results of past studies all indicate a significantly negative relation between age and growth ambition, the reason might be the entrepreneur’s initial goal of growth, or a higher energy level and willingness of younger entrepreneurs to test their abilities as compared to older entrepreneurs Welter (2001).

**Gender of the manager (GEN):** Welter (2001) found a significant difference between the ambition to grow among male and female entrepreneurs.

**Manager/Owner education (EDU):** It is observed that high education level has a positive impact on firm performance in terms of growth (Sapienza & Grimm 1997).

**Previous work experience (W-EXP):** Delmar & Shane (2006) found that founders' entrepreneurial experience and experience with related industry does matter to firm's success. Previous entrepreneurial experience provides tacit knowledge of organizational routines and skills by which they know how to find required resources and how these resources can be appropriately utilized for current business (Delmar & Shane, 2006; Shepherd *et al.* 2000).

**Right advice (ADVICE):** It shows training, advisory and other technical assistance for managers/ owners of MSEs since start up to the time of study. According to Admasu (2012), to make MSEs competitive and profitable, increasing the capacity and skill of the operators through continuous trainings, experience sharing from successful enterprises and provision of advice and consultancy are crucial.

#### **Firm characteristics**

Certain firm characteristics are associated with MSE growth. The relationship between MSE growth and six widely studied firm-level factors in the developing-country literature: sector type, access to market, working premises, access to finance, amount of initial capital and, access to infrastructure are assessed.

**Sector type:** Division of MSEs by sector type was believed to be helpful to study each sector critical factors that affect the performance of MSEs. This is because firms in different sectors of the economy face different types of problems. That means the degree of those critical factors in food processing sector may differ from the factors that are critical to textile and garment and wood and metal work sectors (Admasu 2012).

**Access to market (AC-MKT):** It refers to availability of market or demand to the products/services of MSEs. Esther (2008), showed that access to market plays a significant role in promoting MSEs as result, in this study, access to adequate market is expected to positively correlate with enterprises growth.

**Own premises (PREM):** It shows availability of own working place or industrial land. According to Fred (2003), access to industrial land has been major factors in firm growth and has a positive impact to MSEs growth.

**Access to finance (AC-FIN):** For various reasons ranging from a lack of collateral to bias against small firms, MSEs tend to face greater financial constraints than do larger firms. MSEs in developing countries apply for and receive formal bank loans relatively infrequently; they thus typically rely on other types of credit such as trade credit, overdrafts, and informal loans. Microfinance institutions also provide important sources of financing for MSEs, but their outreach is typically more limited than that of traders who frequently provide working capital in cash or kind, especially in rural areas (Swinen 2005).

**Amount of initial capital (I-CAP):** Access to financial service and the amount of paid up capital in Birr during start-up have positive relationship to growth of MSEs. Larger or more profitable firms are likely to have access to a larger pool of earnings that can easily be reinvested in the firm. On the other hand, small firms that are profitable can reinvest retained earnings but are less likely to get access to a broader set of credit instruments, especially from the formal financial market. Explanation for this goes to inadequate collateral, lack of a significant credit history and inadequate equity capital on their balance sheet, which is a serious barrier to accessing credit by small manufacturing firms that might have been indispensable for their growth and expansion (Okoh & Song 2000).

**Infrastructure (INFR):** The availability of suitable infrastructure to the function of MSEs is important. Infrastructures like electric power supply, water supply, road, telephone, utilities and transports have positive impact on the growth of MSEs and MSEs which have good and enough infrastructures grow fast (Solomon 2004).

**Social Networks (S-NET):** The term "social networks" is used here to refer to relationships between individuals. Having an extensive social network is a valuable asset that can help an entrepreneur obtain access to information (e.g., leads about profitable business opportunities) as well as resources (e.g., credit). While social networks can enhance MSE growth in any context, they can be critical to firms' growth prospects in environments with pervasive market failures. The literature points to the role social networks can play in helping entrepreneurs overcome obstacles related to transaction costs, contract enforcement, and regulation. Social networks also have numerous potential downsides for MSE growth. In some cases, it may be too expensive for or inaccessible to the poorest entrepreneurs, may provide unequal access to resources, lack of stability, may be deeply rooted in societal traditions.

### **Inter-firm cooperation**

Virtually firms interact with other firms. The relationship between inter-firm cooperation and MSE growth can be analyzed considering vertical linkages, horizontal linkages and supporting markets.

**Vertical linkages (V-LNK):** Individual firms form vertical linkages with their buyers and suppliers. Vertical linkages can facilitate MSE growth by expanding a firm's set of viable business opportunities and by improving firm capabilities such as when corporate buyers assist with quality, maintenance, and technical issues (Berry *et al.* 2002) or when input suppliers offer training or information related to the use of improved technologies.

**Horizontal linkages (H-LNK):** Similar firms may group themselves or be organized by an outside party to work together-these are referred to as horizontal linkages. Horizontal linkages can help MSEs overcome many of the disadvantages of being small, providing a way to consolidate production, improve their negotiating position with buyers or suppliers, access market information or services, or lobby for political or regulatory changes (Goldmark & Barber 2005; Steen *et al.* 2005).

**Supporting markets (S-MKT):** Services provided through supporting markets-such as finance; consulting, legal, and tax advice; market information; and skills training-are often directly related to improvements in capacity. For example, skills training may allow firms to offer new products, while finance may allow them to produce greater volumes. Access to market information or new technologies, on the other hand, may help firms seek or respond to new opportunities. Relationship with supporting organization including trade association, universities and vocational schools, financial institutions, local and national level government agencies, and private business service provider. Supporting services may be offered directly to MSEs on a fee-for-service basis, or they may be embedded in firm relationship, that is, delivered through vertical or horizontal linkages. While the absence or weakness of supporting markets is often identified as a constraint on MSE growth (Field *et al.* 2000; Gibson *et al.* 2001; Lusby & Panlibuton 2002)

### **2.4.3. Specification of Logit model for analysis of related diversification of Micro and Small Scale Enterprises**

There are several methods to analyze the data involving binary outcomes. However, for this particular study, Logit model was selected over other methods such as discriminant and linear probability models. Hosmer & Lemeshow (1989) pointed out that the logistic distribution (Logit) has got advantage over the others in the analysis of dichotomous outcome variable in that it is extremely flexible and easily used model from mathematical point of view and results in a meaningful interpretation.

Related diversification is the dependent variable which occurs when the company adds to or expands its existing line of production or markets. In this case, the company starts manufacturing a new product or penetrates a new market related to its business activity.

**Manager/owner education (EDU):** It is observed that high education level has a positive impact on firm performance in terms of growth and diversification (Storey 1994; Sapienza & Grimm 1997).

**Ownership concentration (OWN-CON):** It refers to the direct involvement of the entrepreneur or entrepreneurial team in the effective control of the firm. These features eliminate one of the main causes to pursue a diversification policy, i.e., the agency costs associated to the separation of ownership and control. Amihud & Lev (1999) also found that ownership concentration negatively associated with diversification.

**Entrepreneur's wealth (ENTR-WLTH):** Because the firm may be mainly concentrated in the activities it controls that could induce it to diversify to reduce specific risk, entrepreneur wealth is expected to be positively related to the probability of diversification.

**Firm Size (FRM-SIZE):** This variable is related to the size of the firm resources (e.g human, material, information, financial). It was measured in terms of the change in number of employment. Bigger firms may have more resources to diversify, but their company structure (e.g. bureaucracy) might not allow it. See the research of Fukuda *et al.* (2006) argue that small and medium size companies were more vulnerable during the economic crisis.

**Opportunities (OPP):** This is defined as a case where firms had encountered a chance or favorable environment that facilitate diversification such as local market contingencies, development projects, infrastructure development (e.g. a new road), and personal contacts. This might play an important role in pulling business owner towards diversification.

**Information and communication technology (ICT):** According to Shin (2001), diversification can increase the demand for information and communication technology (ICT) because of the need for coordination of business resources across multiple markets. It is expected to be positively related to the probability of diversification.

**Risk management (RISK-MGT):** Risk management is a further factor often invoked to explain diversification behavior (Ellis 2000). The basic logic of this argument is that previous experience of market failure can provoke

diversification as a means of spreading perceived risk and reducing the impact of total or partial failure on businesses. Hence, it is hypothesized that risk management and diversification are positively related.

**Strengthening the household asset basis (STR-ASSET):** Strengthening the household asset basis can be an additional important factor in diversification choices. In particular, members of better-off household can undertake innovative activities or engage in highly remunerative wage labor (i.e. migrate abroad) with the specific aim of accumulating savings needed to expand the business, offer education opportunities to the young generation, or insure themselves against illness and aging. In addition to that, diversification may also occur as a means to consolidate household natural capital (i.e. to enhance the environmental sustainability of a particular livelihood strategy). Therefore, it is hypothesized that strengthening the household asset basis and diversification are positively related.

**Availability of Key-Assets (KEY-ASSET):** Availability of key-assets (such as savings, working premises, labor, education and/or access to market or employment opportunities, access to common property natural resources and other public goods) is an evident requisite in making households and individuals more or less capable to diversify (e.g. Abdulai & Crole 2001). Investment of a proper mix of the above endowments can be important driver towards diversification. Availability of key asset and diversifications are positively related.

### 3. RESULTS AND DISCUSSION

#### 3.1. General characteristics of Micro and Small Scale Enterprises

##### 3.1.1. Characteristics of business owners or managers

Among the sample respondents included in the analysis, 71.6% of business owners or managers were males and 28.4% were females and the average age of the respondent were approximately 31years. At the time of study, about 46.8% of the owners or managers of the enterprises completed secondary school and only 6.8% and 15.8% of the respondents completed technical and vocational education and training (TVET) and higher education, respectively. The rest (30.5%) of the owners or managers of the enterprise completed primary school education. The compound annual mean growth rate for enterprises owned and managed by those who completed elementary education was 0.39. Whereas the compound annual mean growth rate for enterprise owned and managed by those who completed secondary school was 0.68. The growth rate registered by enterprises owned and managed by graduates of TVET was 0.50. MSEs managers who had diploma and degree from higher college and university have registered growth rate of 0.96 which was the highest compound annual mean growth rate among others (Table2).

Table 2. Educational level of owners or managers and growth rate of enterprises

Educational level	Frequency	Percent	Mean of CAGR	Std. deviation
Elementary completed	58	30.5	0.39	0.24
Secondary completed	89	46.8	0.68	0.57
TVET completed	13	6.8	0.50	0.00
Higher education	30	15.8	0.96	0.29
Total	190	100.0	0.60	0.47

Source: Field survey (2013)

##### 3.1.2. Characteristics of the enterprises

As stated earlier, the sample firms were operating in three sectors of the economy that are construction 142 (74.7%), manufacturing 34 (17.9%), and service 14 (7.4%). Thus, most of them were engaged in construction followed by manufacturing and service. This division of MSEs by sector type was believed to be helpful to study each sector determinants that affect the growth and diversification of MSEs. This is because firms in different sectors of the economy face different types of problems. That means the degree of those determinants in construction sector may differ from the determinants that are critical to manufacturing and service sectors.

The evidence in Table 3 shows that the sample enterprises that were studied had a mean of 4.68years' experience in the business, and Birr 6909.47 paid up capital at start-up. The result showed that small and micro enterprises started their businesses with a capital less than 20000.00 Birr. The study also showed that there were approximately 6 and 7 employees at start-up and at the time of the study, respectively. The mean annual compound growth measure and annual average growth rates were 0.57 and 0.31 respectively. The annual change in job per enterprise was 0.10 which means, on average, each enterprise increased 0.10 individuals in terms of employment annually. The annual compound growth rate and average annual growth rate since start-up indicated

that overall growth performance was low compared to other developing countries by using the same measurement. For instance, the CAGR of small and micro enterprises in Botswana, Swaziland and Zimbabwe were 6.3, 4.1 and 5.6%, respectively. The AAGR of Botswana, Swaziland and Zimbabwe were 8.4, 6.6 and 7.4% respectively (Minilek & Chinnan 2012).

Table 3. Descriptive statistics of enterprise characteristics Variables in the study

	N	Minimum	Maximum	Mean	SD
Owners/managers age	190	19	60	31.76	1.03
Age of the enterprise	190	1	9	4.68	1.89
Employees at start-up	190	1	32	6.48	5.21
Employees currently	190	2	32	7.23	4.73
Start-up capital	190	1000	40000	6909.47	7542.36
Annual compound growth measure (CAGR)	190	-0.17	2.62	0.57	0.46
Annual average growth measure (AAGR)	190	-0.63	3.00	0.31	0.57
Change of job per firm annually (GR)	190	-0.63	0.90	0.10	0.27

Source: Field survey (2013)

Access to suitable working place is the most important factor to MSEs growth and expansions (or diversifications). Large numbers of MSEs which account for 42.6% had working place given by government but most of the working places were not suitable for displaying and marketing their products. About 28.9% of MSEs had working places rented both from government and private owners, 4.7% had inherited their working places where as 23.7% obtained their working places from other sources of production site such as given by NGO (Table 4).

Table 4. Production site at start-up

Production site	Frequency	Percent
Inherited	9	4.7
Rented	55	28.9
Given by the government	81	42.6
Others, such as given by NGO, purchased, lease etc.	45	23.7
Total	190	100.0

Source: Field survey (2013)

As indicated in Table 5, the survey result showed that the majority of enterprises were registered as partnership (91.6%) and few were as sole proprietorship (8.4%). In Ethiopia, cooperatives are tax-exempted and are assisted in organizing and legalizing their entity as cooperatives by Cooperative Promotion Agencies.

Table 5. Form of ownership of the enterprise

Form of ownership	Frequency	Percent
Sole proprietorship	16	8.4
Group (Partnership)	174	91.6
Total	190	100

Source: Field survey (2013)



### 3.1.3. The main source of start-up capital

As shown in Table 6, about 71.6% of start-up capital of sample enterprises came from internal source of finance, especially, personal savings of entrepreneurs, followed by loans from micro finance institutions (16.3%), other sources (9.5%) and family assistance (2.6%). The majority of initial sources of financing for small businesses in Dire Dawa come from personal savings. Credit for start-up both from formal and non-formal financial markets is relatively rare. Banks do not normally practice risk lending to new investors of small enterprises, which do not have a record of accomplishment. Thus, many small enterprises begun with very small amount of capital from personal savings and household assistance, from family, and steadily build up their enterprise by reinvesting profits. Consistent findings were obtained in (USAID 2002; Kawai & Urata 2001).

Table 6. Sources of finance at start-up

Source	Frequency	Percent
Personal saving	136	71.6
Family	5	2.6
Micro finance institutions	31	16.3
Others, such as <i>iqub</i> , loan from friend, donation etc	18	9.5
Total	190	100

Source: Field survey (2013)

Besides, the result of key informants' interview showed that majority of MSEs in the study area use informal sources. The formal financial institutions have not been able to meet the credit needs of the MSEs. The reason for emphasizing on informal sector is that the requirement of collateral/guarantor is relatively rare in this sector. On the other hand, the loans provided by micro financial institutions are inadequate, with a short repayment period, need 20% of the loan amount pre-saving in the micro financial institutions' account and high interest rates. This resulted in limited growth, survival and diversification of MSEs.

The significant numbers of MSEs (81.1%) had shortage of credit and no adequate access to capital through credit. Only 18.9% of MSEs did not have shortage of capital and had access to credit (Table 7). Lack of access to credit or shortage of credit is one of the most significant factors that affect the growth of MSEs which has negative impact on MSEs growth (Mulu 2007).

Table 7. Access to credit facilities by MSEs from formal financial institutions

Access to credit	Frequency	Percent
Yes	36	18.9
No	154	81.1
Total	190	100

Source: Field survey (2013)

In order to investigate factors responsible for inaccessibility of credit, survey respondents were asked to indicate the reasons. As presented in Table 8, some MSEs were discouraged by the bureaucratic processes involved (27.9%), inadequate loan amount (17.9%), lack of collateral (14.2%), no need of credit (10%), high interest rate (7.4%), and other reasons (3.7%).

Table 8. Reasons for not obtaining credit from formal financial institutions

Reasons for not obtaining a credit	Frequency	Percent
I don't need credit	19	10
Inadequate loan amount	34	17.9
High interest rate	14	7.4
Lack of collateral	27	14.2
It is bureaucratic	53	27.9
Others	7	3.7
Total	154	100

Source: Field survey (2013)

With regards to market competition, almost 80.5% of MSEs faced some degree of market competition, 8.4% faced strong market competition while 11.1% had no market competition in their sector (Table 9).

Table 9. Business by level of market competition

Degree of market competition	Frequency	Percent
No competition	21	11.1
Moderate competition	153	80.5
Strong competition	16	8.4
Total	190	100

Source: Field survey (2013)

According to the data presented in Table 10, about 85.8% of the respondents sold their products/services in the local market in Dire Dawa and 14.2% sold their products/services in the external markets inside the country. However, no firms were participating in external market outside the country (export trade) to sell their products/services. But from the interview of the officials, there are opportunities for those who are participating in export trade like pre-saving amount in macro finance account is 15% of their loan amount which is 5% less from pre saving normal amount.

Table 10. Location of product/service selling

Location	Frequency	Percent
For local market	163	85.8
External market inside the country	27	14.2
Total	190	100

Source: Field survey (2013)

#### 3.1.4. Business owners/managers previous experience before start-up

It is expected that owners' or manager's previous experience has a positive impact on enterprise growth. A related business oriented experience gives a person the required technical skill necessary to start and run the business efficiently. The descriptive result of this study supports previous study findings (Liedholm & Mead 1999; USAID 2002). As indicated in Table 11, start-up skills of owners or managers before starting the business were obtained from self-experience (46.8%), on job training (40%), training from business development service (10%) and family (3.2%).

Table 11. Sources of business owners/managers start-up skills

Acquire the skills	Frequency	Percent
Self-experience	89	46.8
Family	6	3.2
On job training	76	40
Training from BDS providers	19	10
Total	190	100

Source: Field survey (2013)

As shown below in Table 12, there existed a strong relationship between the availability of previous experience and the type of business. Manufacturing enterprises were started by people with the related experience than construction and related services enterprises. The percentage value of related experience for manufacturing was 88.24%, and that of service and construction were 71.43% and 61.97%, respectively.

Table 12. Business experience of MSE owners/managers

Type of the Enterprise	Frequency and Percent	Company experience		Total
		Yes	No	
Construction	Frequency	88	54	142
	Percent	61.97	38.03	100
Manufacturing	Frequency	30	4	34
	Percent	88.24	11.76	100
Service	Frequency	10	4	14
	Percent	71.43	28.57	100

Source: Field survey (2013)

Nowadays, in the contemporary business environments internal and external relationship of the enterprises is the most important thing for any type of organization irrespective of their size (large, medium, and small) to work

with co-worker, find input, access market information, distribute output, get training and professional advices, compete and cooperate with other enterprises, etc. Relationships, including social network, horizontal and vertical linkages, and connections to supporting markets, offer many tangible, crucial advantages to MSEs. These advantages include increased production capacity and ways to consolidate production, increased efficiencies, mechanisms to spread both costs and risks, increased bargaining power for inputs or raw materials, and channels to obtain information about and improve techniques used for production, marketing, transportation, and technology. These relationships, then, play a critical role in facilitating MSE growth and diversification. Linkages can expand business opportunities and enhance firm capabilities at the same time. The survey result showed that the percentage of accessing social network (45.8%), vertical linkage (37.9%), horizontal linkage (32.6%) and support market (36.3%) were low which might lead to failure and closure of the enterprises (Table 13).

Table13. Internal and external relationship of the enterprises

Frequency and Percent		Yes	No	Total
Social network	Frequency	87	103	190
	Percent	45.8	54.2	100
Vertical linkage	Frequency	72	118	190
	Percent	37.9	62.1	100
Horizontal linkage	Frequency	62	128	190
	Percent	32.6	67.4	100
Support market	Frequency	69	121	190
	Percent	36.3	63.7	100

Source: Field survey (2013)

### 3.1.5. Sources of growth of different enterprises

The major factors that affect growth and diversifications of MSEs are listed below. Respondents were asked to indicate the degree to which these factors are affecting the growth and diversifications in their business enterprise. Respondents' answers were based on the five likert scale type choice where, 1 = strongly agree, 2= agree, 3 = undecided, 4= disagree and 5= strongly disagree. The result is tabulated below (Table 14).

According to the respondents, major problems which led to failures of business enterprises engaged in construction, manufacturing and service in the study areas were finance (interest rates, collateral requirements, bureaucracies to access finance etc.), marketing (relationship with suppliers and customers, access of market information and others) and premises (absence of their own premises, the rent of house is too high and the current working place is not convenient for their business) which had total mean values of 1.45, 1.73 and 1.89 respectively. The mean value of finance, marketing and premises for each sector were almost the same. The mean scores of 1.52, 1.33 and 1.73 with standard deviation of 0.90, 0.76, and 1.27 of the respondents in Table 17 shows that those operators engaged in construction, manufacturing and service have faced strong problem related to finance respectively. The result also show, majority of respondents strongly agreed with marketing problem. This agreement is justified by the mean scores of 1.75, 1.67 and 1.82 with standard deviation of 1.03, 1.13 and 1.17 for an operators engaged in construction, manufacturing and service respectively. Similarly, respondents of the three sectors strongly agreed with problem related to the premises. This is also justified by the mean scores 1.98, 1.79 and 1.91 with a standard deviation of 1.11, 1.02 and 1.14 for operators engaged in construction, manufacturing and service respectively.

The next major problems which affected the growth and diversifications of business enterprises engaged in construction, manufacturing and service in the study areas were right advices (from financial institutions, legal advices), opportunities (related to market access, infrastructure etc.), technology (lack of appropriate machinery and equipment, skills to handle new technology, money to acquire new technology, etc.), and legalization (government policy, bureaucracies in relation to company registration and licensing), taxation and like which had total mean values of 2.09, 2.09, 2.39 and 2.59 respectively Table 14. The mean scores and standard deviations in Table17 below shows problems related to right advice for enterprises engaged in construction, manufacturing and service. Respondents agreed with absence of right advice from different institutions, NGOs etc. This is justified by the mean scores 1.85, 1.96 and 2.18 with a deviation of 0.73, 1.12 and 1.47 for operators engaged in construction, manufacturing and service respectively. Majority of the respondents of construction and manufacturing agree with opportunities problems related to market access, infrastructure etc. Their mean scores are 2.05 and 1.54 and standard deviations are 1.14 and 0.72 respectively. But, the mean scores and standard deviations for enterprises engaged in service are 2.45 and 1.04. Similarly, the respondents of construction and manufacturing agree with technological problems. Their mean scores are 2.21 and 2.15 and standard deviations are 1.53 and 1.30 respectively. But, the mean scores and standard deviations for enterprises engaged in service are 2.91 and 1.58 respectively. By the same token, respondents of the three sectors agreed with the legalization

related problems. This is justified by the mean scores 2.51, 2.96 and 2.51 with a standard deviation of 1.11, 1.46 and 1.11 for operators engaged in construction, manufacturing and service respectively.

But other problems like access of qualified workers, industrial experience, manager skill, entrepreneurial experience, managers' work load, competitiveness and organizational structure had small effect on the growth and diversification of business enterprises engaged in construction, manufacturing and service in the study area (Table 14).

Table14. Description of common factors that affect the growth and diversifications of MSEs

CONS	MAN		SERV		Total			
Factors	Mean	SD	Mean	SD	Mean	SD	Mean	SD
Qualified worker	3.26	1.49	3.17	1.66	3.45	1.57	3.15	1.52
Industrial experience	3.32	1.35	2.18	0.98	3.75	1.57	3.22	1.42
Manager skill	3.00	1.18	3.46	1.47	3.55	1.50	3.33	1.54
Entrepreneurial experience	3.83	1.22	2.82	1.25	3.38	1.49	3.62	1.28
Market	1.75	1.03	1.67	1.13	1.82	1.17	1.73	1.02
Technology	2.21	1.53	2.15	1.30	2.91	1.58	2.39	1.39
Finance	1.52	0.90	1.33	0.76	1.73	1.27	1.45	0.845
Managers work load	4.34	0.89	3.96	1.46	2.27	1.27	4.12	1.07
Right advices	1.85	0.73	1.96	1.12	2.18	1.47	2.09	1.06
Competitiveness	3.92	1.07	3.25	1.33	4.00	1.34	3.78	1.16
Opportunity	2.05	1.14	1.54	0.72	2.45	1.04	2.09	1.11
Organization structure	4.28	0.76	2.92	1.38	3.09	1.38	4.00	1.02
Premises	1.98	1.11	1.79	1.02	1.91	1.14	1.89	1.09
Legalization	2.51	1.11	2.96	1.46	2.51	1.11	2.59	1.26

Source: Field survey (2013)

#### 4. SUMMARY, CONCLUSION AND RECOMMENDATIONS

##### 4.1. Summary

This research was conducted in Dire Dawa city administration with the general objective of examining determinants of growth and diversification of MSEs in Dire Dawa Administration that are engaged in construction, manufacturing and services activities. Towards this end, the study examined relevant literature, the country's development policies, Micro and Small Businesses Enterprises Development Strategies, Dire Dawa city administration MSEs development program and conducted sample survey by making interviews and observation.

The results showed that most of initial financing for small businesses in Dire Dawa comes from personal savings. Credit for start-up both from formal and non-formal financial markets is relatively rare. Majority of MSEs in the study area use informal sources of finance. The formal financial institutions have not been able to meet the credit needs of the MSEs because of the requirement of collateral. On the other hand, the loans provided by micro financial institutions were inadequate and required with a short repayment period, 20% of the loan amount pre saving in the micro financial institutions account and high interest rates. This resulted in limited growth, survival and diversification of MSEs.

The results also showed that enterprises engaged in construction, manufacturing and services activities included in the study started with an average paid-up capital of Birr 6909.47 and with an average of 6.48 employees. At the time of the study, enterprises included in the study had an average of approximately 7.23 employees. Their major constraints at the time of start-up were lack of sufficient capital, marketing and working space and had approximately similar mean value of each constraint for enterprises engaged in construction, manufacturing and services. The next major problems which affected the growth and diversifications of the three sectors in the study areas were right advices, opportunities, technology, and legalization. Majority of the respondents of construction and manufacturing agree with opportunities and technological problems. Respondents of the three sectors agreed with the right advice and legalization problems.

About 85.8% of the respondents sold their products/services in the local market in Dire Dawa and 14.2% of the respondents sold their products/services in the external market inside the country specially to the nearby cities and rural areas around Dire Dawa. However, no firms were participating in external market outside the country (export trade) to sell their products/services.

The econometric results of growth of MSEs showed that from individual entrepreneur characteristics age of owners/managers, and work experience were statistically significant at 5% significant level respectively and enterprises which were managed or owned by young individuals had high growing ambition than those which were led by aged owners or managers. Experience gained on the job or through prior employment was a critical

growth factor. Firm characteristics related to sector type, access to market, access to working and selling premises, access to finance and, amount of initial capital are the statistically factors affecting MSEs growth. Enterprises which are engaged in manufacturing and access to finance were positively related with growth in employment and they were significant at 5% significance level. Access to market, access to working and selling premises, and the amount of initial capital to start the business also positively and significantly affected growth in employment at less than 1% significance level. There existed negative and significant relationship between owners/managers age, enterprises which are engaged in construction and firm growth at 5% and 10% significance level respectively.

Social networks can help entrepreneurs identify business opportunities as well as overcome a number of obstacles related to transaction costs, contract enforcement, and regulation and it was significant at 5% significant level. Vertical linkage with buyers and suppliers through contractual agreement are directly related to improvements in capacity of MSEs in Dire Dawa and they were statistically significant at 1% significance level. The econometric results of diversification of MSEs showed that opportunities for profitable business and strengthening the household asset basis was positively and significantly related with diversification of enterprises at 1% and 10% significance level respectively. Coordination of production skills, special technology, distribution channel, resource inputs and industry knowledge, through ICT and availability of key-assets such as savings, working premises, education, access to common property and access to market were positively and significantly related to diversification of MSEs at 5% significance level. Moreover, gender of owners/manager was also significant at 10% significance level.

#### 4.2. Conclusion and Recommendations

The findings of this study have important implications for interventions designed to the growth and diversification of MSEs in Dire Dawa Administration city and in other cities. Since MSEs are believed to have a vital role in poverty reduction, employment generation as well as economic development in poor countries like Ethiopia, a special attention should be given to those factors that influence growth and diversification (expansion) of enterprises.

Experience is the most important factor which increases the growth of enterprises and MSEs managed by experienced managers grew more. So creating link between sectors, such as micro finance, TVET, and NGOs providing continuous training based on the growth level of the sectors, experience sharing with other sectors within Dire Dawa and other cities is crucial.

Access to finance was one of the crucial factors that determine the growth of MSEs. Therefore, the Dire Dawa city government bodies should provide affordable alternative sources of finance for MSEs. This can be done by communicating with the banks and other credit institutions to revise their requirements. It is important to create awareness through training given by financial institutions and NGOs to save and manage finance properly. These should be done so that MSEs can get enough access to finance for their business activities.

The government through various relevant departments should specialize more in taking up a facilitative role to give support to the sectors, especially by reviewing all the blockings by laws, to address issues of getting a premises on, and markets. A number of factors should be considered in designing all-encompassing policy for the promotion of the sectors.

The owners/managers of MSEs should form groups (cooperative) and make use of pooled negotiating power for borrowing purposes. They can use such negotiating power to purchase raw materials and receive discounts which might lead to a reduction in the cost of production. Through networking, MSEs of Dire Dawa city can be able to exchange services such as advertising amongst themselves for free, work with exporters and large firms through accepting order and subcontracting work and use common display centers. This will enhance their competitiveness through a reduction of the cost of production. The benefit of sharing such service for the owners/managers of MSEs is that it will strengthen the future survival, profitability and eventual growth of MSEs and external relationship of enterprises with individual, government body and different institutions are created and which affect the firm growth positively and significantly so owners/managers of MSEs give more attention to enhance these relationship.

Opportunities, information and communication technology, strengthening household asset basis, and availability of key-assets had positive impact on diversification of MSEs. owners/managers that will undertake innovative activities to strengthening household assets such as save money, insure themselves against illness and aging so by using these can diversifying their business/market. Owners/managers have to find and use opportunities for firms and key assets that are underutilized within the enterprises have advantage for diversifying the businesses into related businesses or related market. Businesses that are participating in related diversification need to use ICT for coordination of resources. So to use the advantage of related diversification owners/managers ought to use different means of communication and government body should also give attention for this infrastructure.

Gender issue is important in shaping diversification. Business that are owned/managed by female entrepreneur face dual challenges, one is structural problems (problems common to all MSE owners) and the other is women-specific problems such as gender biased practices, socio-cultural factors, unbalanced household responsibilities, unequal access to markets, illiteracy and lack of business skills. Therefore, local and regional government agencies, universities and TVET, financial institutions, private service business providers should give special attention and support for enterprises that are owned/managed by female.

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