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The Level of Business Informality in Tanzanian SMEs and Access to Finance

*Josephat Lotto**

Abstract

The objective of this paper is to assess the level of business informality and access to credit of Tanzania's SMEs. The study considers business informality as a combination of improper keeping of business records, lack of business licenses, lack of business registration and lack of bank accounts. A sample of 295 SMEs and 4 commercial banks were randomly selected from Dar es Salaam, the business centre of Tanzania. The study found that improper keeping of business records was highly impacting SME's access to credit, with other factors such as the lack of business licenses, business registration and bank accounts affecting the access to finance in the same order. The study findings reveal that on average, reasons related to business informality (lack of business registration, poor record-keeping and lack of business license) contributed significantly to difficult access to finance for SMEs compared to other reasons such as the lack of collateral and business plan. In this regard, interventions to increase the levels of formality in the SME sector would have a positive impact on the sector being able to access finance. This can be done through compulsory registration of SMEs at minimal or no cost.

Keywords: *SMEs, Business informality, financial inclusion, impact, access to credit, and commercial banks.*

1. Introduction

The working of a modern market economy is always—and must be—governed by law (MKURABITA, 2008). The mobilization of capital, therefore, should follow the requirements of modern market economy whereby capital is procured outside family members and a circle of acquaintances.

A large share of private sector activity in developing countries like Tanzania takes place outside the formal economy. On one hand, working in informality implies lower regulatory and less tax revenues. On the other hand, informal firms have limited access to formal services like the legal system, and are less likely to hire skilled labour (La Porta & Shleifer, 2014). Crucially, informality is often associated with the lack of access to formal sources of external finance, as both theory and empirical work has shown (Straub, 2005; Beck et al., 2014).

According to ILD (2005) the economy of Tanzania is run with two parallel systems: the formal and informal. It was found that about 98% of businesses and 89% of properties are informal. The value of the assets tied in the informal economy is about US\$29.3bn. According to the ILD (ibid.), this value is four times the value of the net financial flows of multilateral institutions, and nine times the value of foreign direct investment since independence. Furthermore, the study shows that it is impossible for most Tanzanian companies to raise financing through traditional forms of credit, and that micro-financing is also prohibitive.

Be it informal or formal, it is undeniable that small businesses are the engine of economic development in the world, particularly in emerging countries (G20 SUMMIT, 2010). According to the G20 SUMMIT, (ibid.), however, the level of contribution of formal small and medium businesses (SMEs) is higher

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than that of informal SMEs. Informal SMEs contribute over 45% of GDP and over 33% of employment creation. The difference in the level of contribution to economy between formal and informal SMEs is increased by the existing legal, institutional and environmental barriers set and amplified by the banking sector. These barriers limit informal SMEs to operate more efficiently.

The report pinpoints that about 90% of businesses in Tanzania are either sole proprietorship or partnership. However, the law does not recognize the importance of separating business from personal assets of business owners, nor does it make provision for what happens when the owner dies as far as business continuation is concerned. Also according to ILD (2005), Tanzania has unclear laws for separating ownership from control/management of small business so that managements are easily held accountable in periods of underperformance.

According to ESAURP (2012) the problems of informality in African countries are more severe than in the developed countries.

The banking industry in Tanzania and other investors see greater risks in investing in small enterprises since the sector is very fragile with a lot of uncertainties (ibid.). Limited access to finance is one of the key obstacles to the growth of SMEs (Beck et al., 2005). As a result many enterprises are trapped in the informal economy and are unable to innovate and break into the formal economy despite their ability to do so. Consequently, SMEs are so often denied access to the financial and support inputs that are necessary for growth, creation of steady jobs and for poverty reduction (ibid.). The 2009 FinScope (2009) report confirms the existence of inability to access credit by SMEs that relates to both formal and informal financial facilities. The report points out further that while 56% of Tanzanian adults are effectively excluded from financial services, only 12.4% are formally included (ibid.). This number of Tanzanians

excluded from accessing the financial services makes the status of unemployment and poverty even worse in the country.

The overall objective of this paper is to assess the level of business informality of SMEs and their access to credit in Tanzania. The relevance of this paper lies on the importance of SMEs in the economy, including GDP growth, employment creation, entrepreneurial creativity and innovation. The dissemination of the findings of this study will create adequate awareness to SMEs that think it is expensive and unimportant to carry out a formal business. It will further architect commercial banks to design the best ways to deal with SMEs in a most effective manner. The ultimate effect is to have more SMEs formalized and hence smoothen their way to access credits and other essential services.

2. Related Literature

2.1 Theoretical Underpinnings

2.1.1 Information Asymmetry Theory

One of the challenging areas in SME lending is 'information asymmetry' which arises as a result of the different levels of information held by banks as well as SMEs about the future prospects of business (Binks & Ennew, 1996, 1997). Berger and Udell (1998) argue that new businesses are the most opaque in information on account of their lack of any track record of their business. Mostly, the information required to assess the competence and commitment of a SME and its business prospects is either unavailable, uneconomic to obtain or difficult to interpret.

The information asymmetry theory postulates that when two parties are making decisions or transactions, there exists a situation in which when one party has more or better information than the other. Thus, information asymmetry may cause an imbalance of power between the parties. In this context, for example, borrowers are more likely to have more information than lenders. In fact information relating to the risk

associated with an investment is likely to be available to a borrower than to a lender. According to Matthews and Thompson (2008), with information asymmetry, two problems arise for a banker: adverse selection, and moral hazard. Adverse selection is lending to a business that is not creditworthy and not lending to a creditworthy business, which may be due to the lack of useful information on the future of a business. A banker would experience a moral hazard after credit has been made and, due to information asymmetry, and later discovers that the business may hide certain information that might be unfavourable to the bank's interest. It is important that the bank collects adequate information about the future prospects of a SME whilst evaluating its creditworthiness to address the problem of information asymmetry

Financial intermediaries use three major ways to overcome this problem: (i) providing commitment for long-term relationship with clients; (ii) sharing of the information; and (iii) delegation and monitoring of the credit applicants. When the customers borrow money directly from banks, the latter should consider the need for relevant information to be addressed so as to redress the asymmetry of information (Matthews & Thompson, 2008). It is argued that the acuteness of information asymmetries between bankers and entrepreneurs is the main stumbling block to the financing of SMEs in Sub-Saharan Africa. However, the information gap between banks and SMEs can be narrowed by developing financial systems that are more adapted to local contexts. In addition, avenues should be explored for sharing of risks and reduction of perceived risks by banks by promoting sustainable guarantee funds to facilitate better access to financing by SMEs (Leffleur, 2008).

2.1 Empirical Review

Most of the literatures in this area reveal that many economies, particularly the developing countries, operate in dual parallel economic systems: the formal and informal; popularly

addressed as the formal and informal sectors. In the formal sector all exchange and economic transactions are carried out within the ambit of the law, while those of the informal sector operate outside the law. According to De Soto (2000) transactions governed by customary systems are termed as archetypes. The informal business sector has remained in the shadow of the formal economy for so many years (Ihring & Moe, 2004; Schneider & Klingnair, 2004; Schneider, 2007). According to the World Bank (2009), firms in the informal sector typically grow slowly, have poor access to credit and employ fewer employees compared to firms that belong to the formal sector; and the few workers employed in the informal sector remain outside the protection of labour law.

Informality is said to have different dimensions and can be voluntary or involuntary. From one perspective, some firms—or workers—exit from the formal sector based on a private cost-benefit analysis of formality, while others are excluded from state benefits because of high registration costs and regulatory burden (Perry et al., 2007). From a different angle, informality has both inter-firm and intra-firm margins. At the inter-firm margin, some firms, working 'underground', completely hide from the state. Others, at the intra-firm margin, are partly formal and partly informal; which usually happens in the form of misreported sales and hidden workers. This paper focuses on inter-firm margin of informality, i.e., the exclusion of enterprises from the formal economy, be it voluntarily or involuntarily (Perry et al., 2007).

Informality may be either a consequence of poor quality of institutions and weak governance (De Soto, 1989), or a choice that firms make when establishing their operations. Proponents of the former argue that should a government facilitate entry to the formal sector and compliance with tax rules, entrepreneurs will decide to register their businesses. The other view, however, suggests that owners of

start-up firms may opt to remain in the informal sector in response to an entrepreneurial opportunity. Because registration and compliance with product regulations account for a significant proportion of their initial investments (Rand & Torm, 2012), owners may decide to stay under government radar and thus limit their risk taking, especially if future conditions in the business are hard to predict (Siquiera et al., 2014).

Moreover, McKenzie and Sakho (2010) suggest that entrepreneurs decide whether to formalize their business or not depending on which option increases their profitability. Whichever position one takes about the informal sector, efforts to encourage enhancement of the informal sector should go hand in hand with efforts to strengthen the formal sector. Strengthening the formal sector should automatically focus on reducing barriers that prohibit many citizens from participating in the modern market economy (Sparks & Barnett, 2000).

The most common and traditional definition uses business registration and licensing to be the main variables in defining informality. Therefore, the informal sector is referred to as a sector in which enterprises operate outside the formal system. This means that many businesses are unregistered and operate without business licenses.

According to ESAURP (2012), other variables include keeping books of accounts for a business, operating bank accounts, and separation of ownership of assets between the business and the individual owner.

This study adopt the ESAURP (2012) definition that define informal business as a *business enterprise that undertakes business transactions without being registered, having valid business licenses, keeping books of account, bank accounts and without separating business assets from those of the business.*

According to NCR, (2006) a substantial number of SMEs in South Africa are not registered with the Companies and Intellectual Property Registration Commission. The report shows that only 20% of SMEs are registered in South Africa. As a result of not being registered, 84.7% of the SMEs in SA do not have access to formal financial markets.

The responsible organ for business registration in Tanzania is the Business Registration and Licensing Agency (BRELA). According to BRELA, to register a company in Tanzania is a right of those who wish to associate themselves into a company or any other business registration form pursuant to the existing laws. Principal forms for business organization applicable in Tanzania include sole proprietors, partnerships, joint ventures, incorporated company and registered branch of overseas companies. Laws governing business registrations are the Companies' Act, 2000 Cap 212 as amended in 2012 for registration of limited liabilities companies, and the Company Ordinance cap 213 for registration of business names. On registration, BRELA issues a certificate of compliance in the case of foreign company, a certificate of incorporation in the case of a local company, and a certificate of registration in the case of a sole proprietorship and partnerships.

The registration of a business in Tanzania is done only at BRELA's head office in Dar es Salaam. This is a barrier towards business registration because it may increase bureaucracy to register as many businesses as possible. BRELA's offices capable of doing registration should be spread at least in every region. According to the *Doing Business Report* (2015), starting a business in Tanzania takes about 29 days, hence a businessman from upcountry may spend that long period in BRELA's headquarter just completing a registration process. Hence, the decentralization of the registration process to regions may be of great importance in increasing the easiness to register businesses.

The *Doing Business Report* (2015) also shows that among Sub-Saharan African countries, Tanzania ranks number 113th in the ease of starting a business. On average the regional (Sub-Saharan Africa) ranked 123rd. Other countries for comparative purpose to Tanzania on the ease of starting business and their ranks are: South Africa (53rd), Mozambique (96th), Botswana (99th), Kenya (126th), Malawi (141st) and Uganda (144th).

A business license is a legal authorization to operate a business in a city, municipal, country or state. It confirms permission to do business. In Tanzania, business licensing procedures are governed by the Business Licensing Act No 25 of 1972. According to the Act, the Business License Application Form (TFN 211) requires the business premises any person applying for business license to be inspected by health/town planning officers before being issued with a business license. Also one will need to have evidence of registration and business license before opening a business bank account.

In most jurisdictions, the law requires SMEs to prepare financial statements and, often, to have them audited. Normally, financial statements are filed with the government, posted on a website or are made available on request (EC, 2008). According to EC (2008), appropriate accounting information is important for a successful business entity, whether large or small. Thus SMEs are required to report reliably their full financial statements (World Bank, 2008).

In Tanzania, the Companies Act, cap 212, requires companies to keep accounting records and prepare audited accounts for various purposes. However, according to Mittah (2009), most SMEs do not keep proper records with a view to remain informal so as to avoid tax liability. In the context of taxation formal SMEs are well structured and have the capacity to keep records that conform to the accounting standards and tax laws. However,

informal SMEs are not well-structured and may have genuine difficulty in keeping adequate records. Financial institutions require financial information to assess the financial health of a business before granting any loan.

Keeping proper books of account provides input in the preparation of financial statements. The absence of proper books of accounts suppresses the bankers' interest to lend SMEs. Many suppliers of financial credit have little interest of lending to SMEs that lack books of accounts (World Bank, 2008). It is further observed that financial opaqueness¹ has been the main reason why bankers are unwilling to lend to SMEs. Financial institutions are willing to enter into relationship that is impersonal. Impersonal relationship (or at arm's length financing) requires objectivity and transparency in operations. It is through financial statements that impersonal relationships can be build.

According to OECD (2006), commercial banks as a group are the main source of external finances (credits) for SMEs. However, SMEs consider bank conditions to be barriers for their access to credit. Maintaining and operating bank accounts is one of the requirements to qualify for a loan. It is through bank accounts that bankers are able to assess the financial discipline of a SME.

According to MKURABITA's (2008) diagnostic study, most Tanzanians companies face difficulties to acquire capital from the formal credit market because most operate informal businesses. As a solution to this problem, the NCR (2011) report recommended the level of formality of SMEs to be increased. Some of the reasons the report suggested for doing so include the following; *first*, a registered SME is more likely to have a bank account to make use of credit product;

¹ Financial opaqueness refers to the difficulty in accessing if a firms has the capacity to pay (it has viable projects) and/or if it is willing to pay (due to moral hazards).

second, a registered SME makes a distinction between owner's personal assets/finances and business assets; *third*, registering a SME separates it legally from its owner.

Whether a business is registered or not, it is often difficult to separate personal assets of small business owners from business assets; a factor that negatively impacts the ability of a SME to access finance (OECD, 2006). According to Sweeney (2010) many people do not want their personal assets to be exposed to business risks since personal assets not separated from business assets are in the risk of exposure to liability related to business legal litigations.

As mentioned earlier, ILD (2005) reports that 90% of the businesses in Tanzania are sole traders and partnerships, but there are laws requiring the separation of business and one's personal assets. According to the World Bank (2008), informality related to non-separation of business owner's personal assets from business assets implies that a firm has no recorded liabilities belonging to its employees and government hence business owner take all liabilities as his/her own

Access to credit is one of the benefits of business formalization. According to Ishengoma and Kappel (2006), the benefits of formalization include freedom from corruption and embarrassment, and access to business development services (BDS). BDS include finance (loans, grants, and subsidies), public procurement opportunities, management support, training opportunities and information services, freedom to cooperate with other partners and state protection.

Owners of informal sector are unable to get loans because of the lack of collateral (De Soto, 2000). As mentioned earlier, access to credit remains to be one of the key constraints in the development SMEs in emerging economies (G20 SEOUL SUMMIT, 2010). According to

NCR (2011), there is a significant SMEs credit financing gap in most developing countries. NCR (ibid.) defines financing gap as a situation where a sizable proportion of economically significant SMEs cannot obtain financing from banks, capital markets or any other supplier of finance. This gap is caused by the fact that SMEs operating in the informal sector do not qualify for financial assistance from the formal financial system.

According to the FinScope survey, SMEs have limited access to credit due to various reasons, including: low awareness of financial products, low level of education, the absence of recognized identities and property, the lack of fixed business premises and proof of address and referees, the lack of sufficient collateral, and the lack of bank accounts.² Financial institutions require the balance sheet of a business before approving the issuance of a credit to a business. A business whose balance sheet includes the personal assets of the owner might not be able to manage its loan properly. SMEs that cannot separate owner's assets from their business assets are full of uncertainties. And bankers are sceptical to establish a lending relationship with firms that are surrounded with a lot of uncertainties.

The *Doing Business Report* (2015) looked at how well does credit information system, collateral and bankruptcy laws in Tanzania facilitate access to credit. Basically, Tanzania scored zero on the depth of credit information index, and 7 on the strength of legal rights index. The full potentials of Tanzania's SME sector have not been adequately tapped. Constraints against the potentials of SMEs include unfavourable legal and regulatory framework, underdeveloped infrastructure, poor business development services, ineffective and poorly coordinated institutional support framework, and limited access to finance.

²According to Finscope (2009), 90% of Tanzanians had never had bank accounts. Similarly, ESAURP (2011) revealed that 61% of enterprises have no bank accounts

The World Bank Enterprise Survey of 2008 reported the following on SMEs in Tanzania:

With respect to the use of credit products; none of the unregistered firms made use of any credit products although 13% had applied for a loan but all had been rejected, whereas 25% of registered firm did. As a result 58% of the unregistered firms reported access to credit as the major obstacles to their business development.

.....
Increasing level of formality also mean additional reporting requirements, thus promoting the availability of information on a business, the lack of which can also be an impediment to accessing financing.

3. Methodology

The objective of this study was to assess the level of business informality in Tanzanian SMEs and their access to credit. The study is descriptive in nature and falls under applied research because it deals with a real, objective, live and dynamic subject; hence its results can be used practically to improve the business status of SMEs in the future in terms of business formalization. Primary data were collected from small businesses in Dar es Salaam, the business city of Tanzania, through questionnaires that were administered to 295 correspondents. Out of the 350 businesses approached, 55(14%) rejected to administer the questionnaires.

Furthermore, structured interviews were carried out with authorized officers in four commercial banks that serve SMEs, namely, the Tanzania Postal Bank (TPB), Azania Bancorp (AB), BOA Bank (BOA) and Mkombozi Commercial Bank (MCB). These banks were chosen because they are the ones that currently have special window for SME clients. The exercise was meant to explore the entire loan process from application to issuance. Conditions necessary for a SME to qualify for credit from a commercial bank were also explored in depth. The interviews further explored the number of loan applicants who were successful and those who were unsuccessful so as to see the extent and reasons for unsuccessful applicants. In some cases strategic bank officers were

interviewed to obtain information on the performance of SMEs in their respective banks. Secondary data was collected through documentary review from the commercial banks—i.e., TPB, AB, BOA and MCB. Data was analyzed using SPSS and presented using frequency distribution table, pie charts and bar charts.

4. Results and Interpretation

4.1 Level of Business Formality

4.1.1 Business Registration and Licensing

As said earlier, all businesses in Tanzania are required to be registered by the BRELA, regardless of whether they are individual businesses, partnerships, or corporations. Therefore, formal businesses comprise all enterprises formally registered by BRELA. The size of an enterprise size does play any role as far as formality is concerned. All business activities that are not registered are thus regarded as informal activities.

However, in this survey a less strict definition of formality was used such that businesses that held any long-term licenses were also regarded as formal. Such licenses included operating and market licenses by municipalities, but excluded daily trading licenses. A tax identification number (even if solely used for business) held by a small business owner was not regarded as a long-term license. As can be seen from Fig. 1, only 52% of business respondents were registered by BRELA. 55% of the registered businesses are sole proprietors, 39% are registered to operate partnership business, while 6% reported to have registered but could not know their exact business registration form.

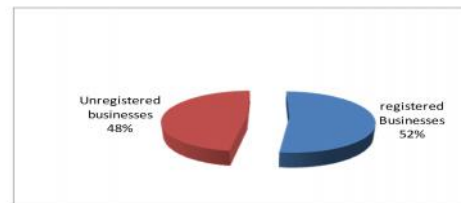


Figure 1: Business Registration Status

Impliedly, on the basis of business registration component only 52% of businesses qualify for bank loans. Fig. 2 shows the status of business licensing. Only 3% of the businesses have business licenses, 94% operate without business licenses while 3% do not know. The results created room for further inquiry as to as to why so many businesses operated unlicensed.

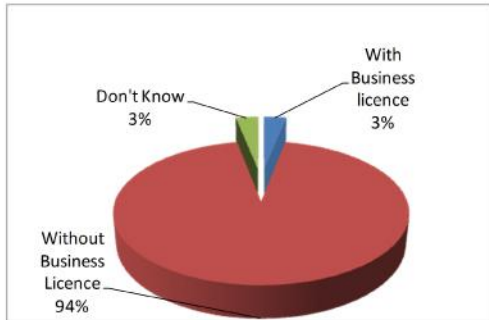


Figure 2: Business Licensing Status

The results revealed that there were some procedural changes in the duration of a license. Before July 2015, business licenses were everlasting. With effect from July 2015 the duration of a license changed to one year. As a result, at the time of collecting the data many businesses had expired licenses requiring renewal. On the basis of business licensing, like in business registration, only 3% of businesses would qualify for bank loans.

5. Keeping Business Records

Running a successful business entails keeping accurate and timely financial information. A clear financial picture allows SMEs to monitor the success or failure of a business. A good record keeping system also provides the information one needs to evaluate the financial consequences of financial decisions. Fig. 3 shows the status of keeping business records by SMEs. 18% of the respondents keep no business accounting records, the remaining 82% keep records of some kind.

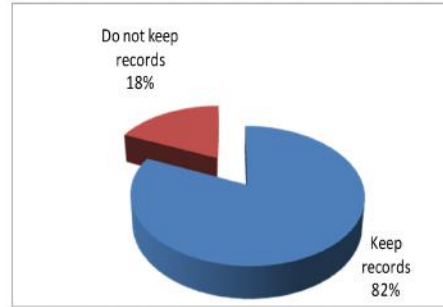


Figure 3: Business Records Keeping Status

The proportion of business respondents who keep business accounting records is very high and encouraging. Further enquiry was made to reveal whether such records are internally prepared or not. It was observed that 76% of the businesses accounting records are kept by owners, 19% use audit/accounting firms, while 5% use their own employees to prepare and keep business records (Fig. 4).

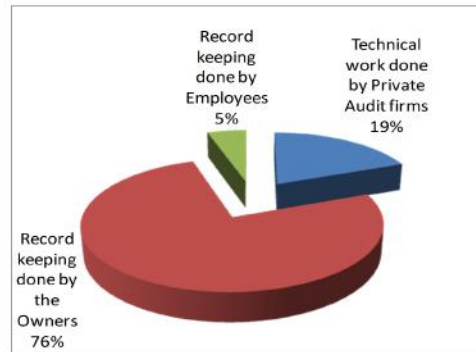


Figure 4: Keeping Business Accounts Ability

5.1 Maintenance of Bank Account

Fig. 5 shows that 55% of the maintain bank accounts for their businesses while 45% of the respondents do not operate bank accounts. Therefore the 45% part may not qualify for bank loans.

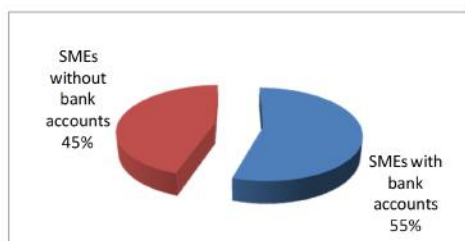


Figure 5: Maintenance of Bank Account Status

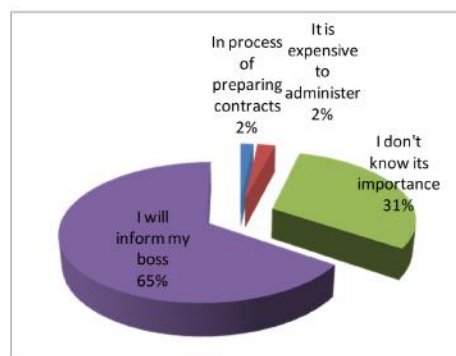


Figure 6: Reasons for Maintaining Employment Contracts

5.2 Separation of Individual from Business Assets

The study used employment formalities to assess the business ability to separate its assets from those of individual owners and employees. Using employment contracts, the study found that all respondents do not maintain written employment contracts: all employments contracts are made through word of mouth. Fig. 6 shows reasons advanced by respondents on not keeping employment contracts. According to the figure, 65% responded that they will inform their bosses, while 31% said that they did not know the importance of keeping employment contracts, 2% said that they are in process of establishing employment contracts, while the remaining 2% said it is expensive to administer. Therefore, the level of informality on the basis of not keeping employment contract is 100%.

3. Banks' Views on SMEs Borrowing Capacity

3.1 Loan Applications and Processing

Fig. 7 shows the number of loan applications in the four banks in the period January, 2014, to October, 2015. The Tanzania Postal Bank (TPB) received 645, BOA Bank (BOA) received 400, Mkombozi Commercial Bank (MCB) received 5,774, while Azania Bancorp (AB) received 357 applications during the period. Percentage-wise, 93.5% of the processed applications were successful, and 6.5% were unsuccessful. Bank-wise, Table 1 shows the status of successful applications.

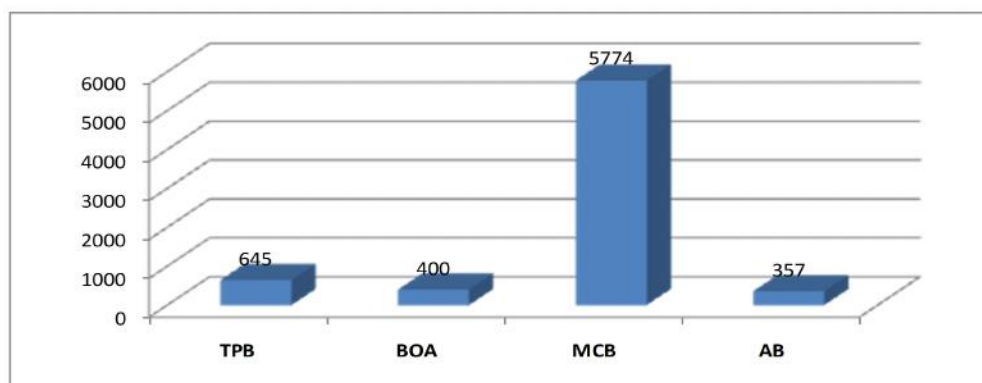


Figure 7: Loan Applications from SMEs received and Processed for the last year

Table 1: Successful loan applicants

Commercial Bank	Successful Applicants	Unsuccessful Applicants	Total Applicants	Successful Applicants In Percentage
TPB	474	171	645	73.5
BOA	360	40	400	90.0
MCB	5700	74	5774	98.7
AB	172	185	357	48.2
Overall	6706	470	7176	93.5

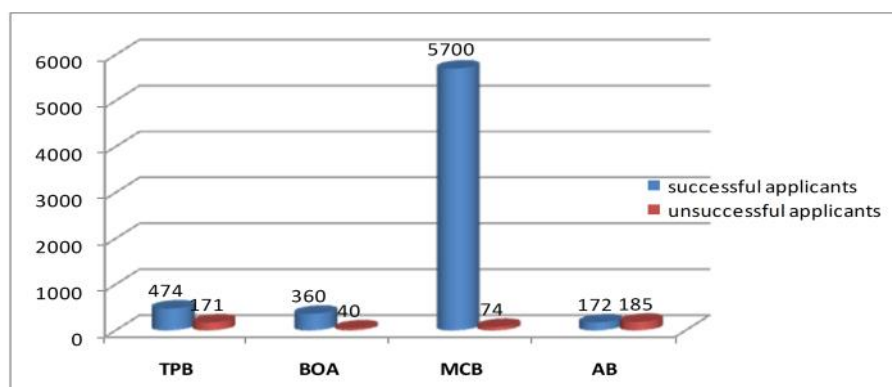


Figure 8: Number of successful and unsuccessful loan applicants

Fig. 8 provides a diagrammatic representation of successful and unsuccessful applicants. However, it is worth noting that the number of applications received does not include applications rejected before processing.

5.3 Factors Influencing Banks to Reject SMEs' Loan Application

Access to finance has remained one of the most critical factors affecting the competitiveness of Tanzania's SMEs, and most banks in Tanzania have been so reluctant to offer loans to SMEs because of several reasons as previously noted by Neema et al. (2012). According to them such reasons include the lack of enough information from SMEs to enable banks perform the required analyses, the lack of awareness on the part of SMEs as to why they do the business they are doing, limited knowledge on financial management unfaithful utilization of funds outside of what a loan is requested for, lack of collateral, poor performance, and stagnant businesses.

Banks normally require more information to evaluate potential risks associated with SME businesses. The flow of information in the financial market is crucial for both SMEs and financial providers (Falkena et al., 2001). Therefore, this paper infers that the availability of information is essential to both the banks and SMEs. In this paper banks visited revealed six information items that a borrower had to disclose before securing credit from any bank. These issues include business license, business accounting records, business registration certificates, collateral, bank account and business plan. If any of these information items falls short during loan application, it will be rejected. The study results, as revealed in Table 2, show that it was precisely because of these reasons that the four banks rejected loan applications from SMEs.

Table 2: Loans Rejection Status and Reasons for Rejection

Reasons for rejection of loan applications	Overall rejections situation for the four banks	Rejection percentage	Rank
Lack of proper records	433	92%	1
Lack of collateral	415	88%	2
Lack of business plan	405	86%	3
Lack of Business License	285	61%	4
Lack of business registration	255	54%	5
Non maintenance of bank accounts	89	19%	6

Fig. 11 shows a ranking of the reasons for banks turning down financial requests from SMEs. The top reasons cited were poor record keeping, insufficient collateral and lack of business plan. These were followed by the lack of business license, lack of business registration and lack of bank account in the same order.

The results further show that business informality contributes significantly to the failure of SMEs to access credit from banks.

On average, reasons related to business informality (lack of business registration, poor record keeping, lack of bank account and lack of business license) contributed significantly to the difficulty of SMEs in accessing finance (the respondent banks mentioned business informality aspects as reasons for rejecting 973 loan applications) compared to other reasons highlighted in this paper such as the lack of collateral and business plan as Fig. 12 shows.

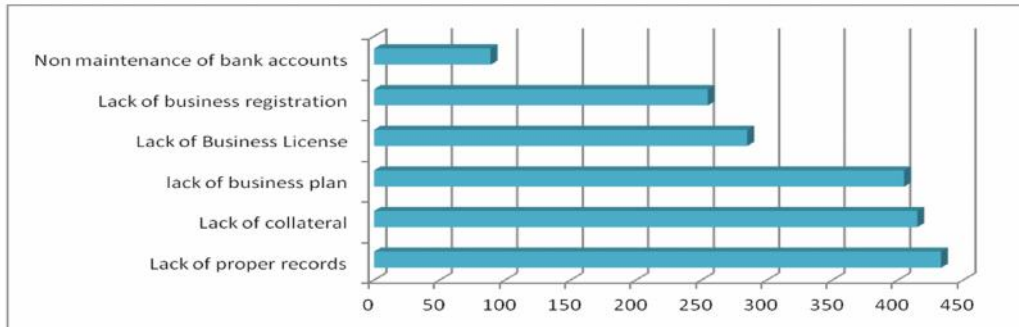


Figure 11: Reasons for Rejecting SMEs Loan Applications

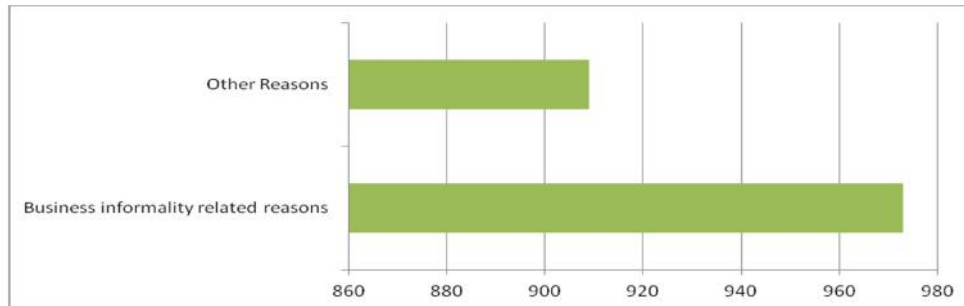


Figure 12: Reasons for SMEs Poor Access to Finance Categorically

These results are consistent with the results of previous surveys of SMEs and financial institutions by FinScope (2009) and Neema et al., (2012) who report that banks are heavily reluctant in lending SMEs due to business informality reasons and the lack of collateral and business plans.

6. Conclusions and Recommendations

The objective of this paper was to assess the level of business informality of SMEs in Tanzania and their access to credit. The enquiries were made through administration of face-to-face questionnaires to 295 respondents. The study also assessed the sources of capital for the initial and current situation of SMEs to check the involvement of commercial banks in supplying capital to SMEs. The study findings shows that almost half of the business were not registered with BRELA; almost all businesses were either not licensed or used expired business licenses; and less than a quarter of the businesses did not keep proper business accounting records. Furthermore, less than half of the respondents did not maintain bank accounts. On average the level of business informality for the respondent SMEs was over 50%. The paper also confirms that most of the SMEs applying for capital from the banks were not successful due to being informal: i.e., lacking proper business records, having unregistered business, lacking business license, lacking bank accounts and also due to non-separation of individual assets from business ones.

Generally, the paper confirms that business informality has an impact on SMEs' access to credit from commercial banks. To improve the situation, the paper recommends the government of Tanzania should extensively increase its efforts to formalize as many SMEs as possible. As revealed in this paper, registered SMEs are more likely to have a bank account and make use of credit products. Moreover, because of the difficulty of separating personal finances of SME owners

and that of their businesses, registering SMEs make it easier to make this separation because business registration laws separate a business from its owner, thereby reducing the probability of an application for credit being rejected. Increasing the levels of formality also mean additional reporting requirements, thus promoting the availability of information on a business, the lack of which can also be an impediment to accessing financing.

In this regard, interventions to increase the levels of formality in the SME sector would have a positive impact on the SME sector being able to access finance. This can be done through compulsory registration of SMEs that have not yet registered, at minimal or no cost to the SMEs. SMEs can be incentivized by highlighting the benefits of registration such as access to financing from various government (and private) schemes, and access to other support programs such as business development services (BDS), also at a minimal or no cost.

The paper also recommends the implementation of the Public Private Partnership Act (PPP) be adequately extended to include a business formalization agenda. Likewise, the Bank of Tanzania (BoT), which is the governing instrument for credit and financial inclusion in the country, should intensify efforts to include as many SMEs as possible. Also, public education on how to access finance should be given to as many entrepreneurs as possible.

Furthermore access to credit by SMEs still requires some specific attentions from change of mindset of the SMEs, bankers and the society at large. To mitigate the situation further researches are recommended in the following areas: (i) the role of business technical education in access to finance; (ii) the level of financial exclusion for SMEs in the country; and (iii) the role of PPP in the growth of SMEs in the country.

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