

Innovations

Financial Literacy Levels of Small and Medium Enterprises in Ethiopia

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Abstract: *This study aims to assess the financial literacy levels of small and medium enterprises (SMEs) in Southern Ethiopia, focusing on three zones: Gamo, Wolayit, and Gofa. The research seeks to understand the relationship between financial literacy, financial service utilization, and the overall sustainable development of SMEs. A cross-sectional survey design was employed, targeting a population of 6,327 SMEs across the three zones. Using the Yamane formula, a sample size of 376 SMEs was determined. Data were collected through a structured questionnaire that assessed financial literacy levels, financial service utilization, and demographic information, including age, education, and gender. Descriptive and inferential statistics were used to analyze the data. The study revealed significant variations in financial literacy levels among SMEs, with the Gamo zone showing the highest mean score (75.3) and Gofa the lowest (62.4). Differences in financial literacy were also noted across sectors, with manufacturing SMEs exhibiting the highest scores (78.5) and trade and services sectors showing lower levels (65.9 and 64.5, respectively). A strong positive correlation ($r = 0.65$, $p < 0.01$) was found between financial literacy and the utilization of financial services. Furthermore, demographic factors such as education level and age were positively associated with financial literacy. The findings highlight the critical need for targeted financial literacy programs tailored to the unique contexts of different zones and sectors. Policymakers and financial institutions should prioritize enhancing financial education, particularly in underperforming areas like Gofa, to improve SMEs' access to financial services and foster sustainable economic development. Additionally, addressing gender disparities through gender-sensitive approaches in financial literacy initiatives is essential for empowering women entrepreneurs.*

Keywords: *Financial Literacy, Small and Medium Enterprises, Sustainable Development, Southern Ethiopia, Financial Service Utilization*

Introduction

Small and medium enterprises (SMEs) are recognized as critical drivers of economic growth and employment in developing countries, including Ethiopia. They play a significant role in enhancing innovation, fostering competition, and contributing to poverty alleviation (World Bank, 2020). However, SMEs often face numerous challenges that hinder their growth and sustainability, particularly in accessing finance, managing resources, and adopting effective financial practices. One of the primary obstacles is the lack of financial literacy among entrepreneurs, which is essential for informed decision-making and effective business management.

Financial literacy is defined as the ability to understand and use various financial skills, including budgeting, saving, investing, and managing debt. It is widely acknowledged that financial literacy significantly impacts individuals' and businesses' financial behaviour, affecting their ability to access financial services and make sound financial decisions (Lusardi & Mitchell, 2014). In the context of SMEs, financial literacy can influence the utilization of financial services, which is crucial for securing necessary funds for growth and investment.

In Ethiopia, the financial literacy landscape remains underexplored, particularly concerning SMEs in rural areas. Previous studies have highlighted disparities in financial literacy levels across different regions and sectors, indicating that socio-economic factors, education, and gender dynamics play a critical role in shaping financial knowledge and skills (Kaiser & Menkhoff, 2017). This lack of understanding poses a significant barrier to the effective utilization of financial services, ultimately impacting the sustainability and development of SMEs.

This study aims to assess the financial literacy levels of SMEs in Southern Ethiopia, focusing on three key zones: Gamo, Wolayita, and Gofa. The research seeks to explore the relationship between financial literacy and the utilization of financial services, as well as the implications for sustainable development among SMEs. By identifying the specific financial literacy needs and challenges faced by entrepreneurs in these zones, the study intends to provide valuable insights for policymakers, financial institutions, and educational organizations.

The objectives of this study are as follows:

1. To evaluate the financial literacy levels of SMEs across different sectors in Southern Ethiopia.
2. To assess the utilization of financial services among SMEs and its correlation with financial literacy.
3. To provide recommendations for enhancing financial literacy and service utilization to promote the sustainable development of SMEs in the region.

By addressing these objectives, this research aims to contribute to the existing body of knowledge on financial literacy and its importance in fostering the growth and sustainability of SMEs in Ethiopia. Ultimately, improving financial literacy among entrepreneurs can empower them to make informed decisions, enhance their business performance, and contribute to the overall economic development of the region.

Literature Review

1. Overview of Financial Literacy Theories

Financial literacy encompasses a range of knowledge, skills, and attitudes that enable individuals and businesses to make informed financial decisions. Several theories have been proposed to understand the dynamics of financial literacy, its determinants, and its implications for behaviour.

a. Human Capital Theory

Human Capital Theory posits that individuals invest in education and training to enhance their skills and capabilities, leading to improved economic outcomes. In the context of financial literacy, this theory suggests that individuals and entrepreneurs with higher levels of education and training are more likely to possess financial knowledge and make informed financial decisions (Becker, 1993). Research has shown that entrepreneurs who invest in their financial education are better equipped to navigate the complexities of financial markets, resulting in enhanced business performance and sustainability (Lusardi & Mitchell, 2014).

b. Theory of Planned Behaviour

The Theory of Planned Behaviour (TPB) explains how individual behaviour is influenced by attitudes, subjective norms, and perceived behavioural control (Ajzen, 1991). In the financial literacy context, TPB suggests that individuals' attitudes towards financial management, the influence of social norms regarding financial practices, and their perceived ability to engage with financial products significantly affect their financial behaviour. This theory provides a framework for understanding how financial literacy can lead to proactive financial behaviour among SMEs, such as seeking financial services and making informed investment choices.

c. Social Learning Theory

Social Learning Theory, developed by Bandura (1977), emphasizes the role of observation and modelling in learning behaviours. In terms of financial literacy, this theory posits that individuals acquire financial knowledge and skills by observing the behaviour of others, particularly peers and role models. For SMEs, this suggests that entrepreneurs can benefit from mentorship programs and peer

networks that facilitate knowledge sharing and learning about effective financial practices.

2. Impact of Financial Literacy on SME Development

The impact of financial literacy on the development and sustainability of SMEs has been extensively documented in the literature.

a. Access to Financial Services

One of the primary areas where financial literacy influences SME development is in access to financial services. Research indicates that entrepreneurs with higher financial literacy levels are more likely to engage with formal financial institutions, leading to increased access to credit and other financial resources (World Bank, 2020). This relationship is critical in developing countries, where informal financing options may limit SMEs' growth potential. For example, a study by Cole et al. (2011) found that financially literate entrepreneurs are more adept at understanding and navigating the loan application process, improving their chances of securing funding.

b. Financial Management Practices

Financial literacy also plays a crucial role in enhancing SMEs' financial management practices. Entrepreneurs equipped with financial knowledge are better positioned to create budgets, manage cash flow, and make investment decisions (Menkhoff et al., 2017). A study by Aterido et al. (2013) highlighted that SMEs with higher financial literacy scores exhibited better financial planning and control, which are essential for sustainable growth and resilience.

c. Business Performance and Sustainability

The connection between financial literacy and overall business performance is well-established. Research shows that SMEs with financially literate owners are more likely to achieve higher levels of profitability, operational efficiency, and growth (Lusardi & Mitchell, 2014). Financial literacy enables entrepreneurs to identify and mitigate financial risks, adapt to market changes, and seize new opportunities, thus fostering sustainable development.

d. Economic Development and Job Creation

At a macroeconomic level, improved financial literacy among SMEs contributes to broader economic development and job creation. As financially literate entrepreneurs succeed in their businesses, they contribute to economic growth by creating jobs, fostering innovation, and enhancing competition in the marketplace (OECD, 2016). This ripple effect underscores the importance of promoting financial literacy as a means to bolster the entrepreneurial ecosystem and support economic resilience in developing regions.

Numerous studies have established a positive correlation between financial literacy and business success. For instance, Lusardi and Mitchell (2014) found that financially literate entrepreneurs are more likely to make informed business decisions, leading to better financial outcomes. Theoretical frameworks suggest that higher financial literacy leads to improved financial decision-making, resulting in better business outcomes (Atkinson & Messy, 2012). This literature review synthesizes existing research on financial literacy and its implications for SME development, emphasizing the necessity for tailored financial education programs.

3. Gaps in the Literature

Despite the extensive research on financial literacy and its impact on SMEs, several gaps remain. Much of the existing literature has focused on urban contexts, leaving rural areas and developing regions like Southern Ethiopia underexplored. Additionally, there is a need for research that examines the specific challenges faced by SMEs in these contexts regarding financial literacy and access to financial services. Understanding these dynamics is crucial for developing targeted interventions that can effectively enhance financial literacy and promote SME development.

Conclusion

The theories of financial literacy provide valuable insights into how financial knowledge and skills influence the behaviour of entrepreneurs and, consequently, the development of SMEs. By recognizing the critical role of financial literacy in enhancing access to financial services, improving financial management practices, and contributing to overall business performance, stakeholders can implement strategies that empower SMEs, ultimately supporting sustainable economic development.

Methodology

1. Study Design

This study employs a cross-sectional survey design to assess the financial literacy levels of small and medium enterprises (SMEs) in Southern Ethiopia. This design allows for the collection of data at a single point in time, providing a snapshot of financial literacy across different zones and sectors. This approach is particularly effective for identifying relationships between financial literacy and the utilization of financial services.

2. Data Source and Type

The primary data source for this study is a structured questionnaire developed to measure financial literacy, financial service utilization, and demographic characteristics of SME owners. The questionnaire was constructed based on existing literature and tailored to the Ethiopian context, ensuring that it captures the unique financial challenges faced by SMEs. The data collected are quantitative in nature, enabling statistical analysis to draw meaningful conclusions.

3. Target Population

The target population for this study comprises 6,327 SMEs operating in the Gamo, Wolayita, and Gofa zones of Southern Ethiopia. These SMEs were selected due to their significance in the local economy and the necessity for enhanced financial literacy to support their growth and sustainability.

4. Sampling Technique and Sample Size

A stratified random sampling technique was employed to ensure representation across the three zones and various sectors. The Yamane formula was utilized to determine the appropriate sample size for the study:

$$n = \frac{N}{1 + N \times e^2}$$

Where:

- n = sample size
- N = population size (6,327 SMEs)
- e = margin of error (assumed at 0.05)

Substituting the values into the formula yields a sample size of 376 SMEs, which is deemed statistically significant for the analysis.

5. Data Collection Instrument and Procedure

Data were collected using a structured questionnaire administered through face-to-face interviews. The questionnaire consisted of three main sections:

- **Financial Literacy:** Questions assessed knowledge and understanding of basic financial concepts, budgeting, saving, investing, and financial products.
- **Financial Service Utilization:** it explored the extent to which SMEs utilize financial services offered by formal and informal institutions.
- **Demographic Details:** Questions on age, education level, and gender of the respondents were included to facilitate a comprehensive analysis.

The data collection process involved trained enumerators conducting interviews with SME owners at their business premises, ensuring clarity and accuracy in responses.

6. Data Analysis

The collected data were analysed using statistical software SPSS to perform descriptive and inferential statistics. Descriptive statistics provided insights into the demographic characteristics of the respondents and the overall financial literacy levels. Inferential statistics, including correlation and regression analyses, were used to explore the relationships between financial literacy, service utilization, and demographic factors.

7. Model Specification

The study employed a regression model to analyse the impact of financial literacy on financial service utilization, controlling for demographic variables such as age, education, and gender.

The model can be specified as follows:

$$\text{Service Utilization} = \beta_0 + \beta_1 \text{Financial Literacy} + \beta_2 \text{Age} + \beta_3 \text{Education} + \beta_4 \text{Gender} + \epsilon$$

Where:

- Service Utilization = dependent variable (extent of financial service utilization)
- Financial Literacy = independent variable (financial literacy score)
- β_0 = constant term
- $\beta_1, \beta_2, \beta_3, \beta_4$ = coefficients of independent variables
- ϵ = error term

8. Ethical Considerations

Ethical considerations were prioritized throughout the study. Informed consent was obtained from all participants before data collection, ensuring they were aware of the study's purpose and their rights to confidentiality and voluntary participation. The anonymity of respondents was maintained by assigning unique identifiers to each questionnaire. Furthermore, the study adhered to ethical guidelines set forth by relevant institutional review boards, ensuring that the research was conducted with integrity and respect for participants.

Validity and Reliability

Validity:

- **Content Validity:** The questionnaire comprehensively covers financial literacy dimensions, including financial knowledge, behaviour, and attitudes.
- **Construct Validity:** Factor analysis confirmed that items clustered as expected into financial knowledge, behaviour, and attitude, supporting construct validity.
- **Criterion Validity:** Financial literacy scores positively correlate with business sustainability metrics, affirming criterion validity.

Reliability

- **Internal Consistency:** Cronbach's Alpha for financial literacy items is above 0.7, indicating good internal consistency and reliability.
- **Test-Retest Reliability:** High correlation ($r > 0.8$) on re-administration demonstrates stability over time.

Results

1. Overview of Financial Literacy Levels

The analysis of financial literacy levels among SMEs in Southern Ethiopia reveals significant variations across the three zones—Gamo, Wolayit, and Gofa—as well as across different business sectors, including manufacturing, trade, and services. Financial literacy was assessed through questions on budgeting, saving, borrowing, investment knowledge, and understanding of financial products. The mean financial literacy score across all SMEs was 69.5, indicating moderate levels of financial literacy, though with substantial differences based on geographical and sectorial factors.

Financial Literacy Levels across areas (Zones)

The assessment of financial literacy levels among SMEs across the three zones—Gamo, Wolayita, and Gofa—highlights distinct variations that may be attributed to differences in resource accessibility, education levels, and financial service availability within each area.

Table 1 presents the mean financial literacy scores by zone.

| Area (Zone) | Mean Financial Literacy Score (%) |
|--------------------|--|
| Gamo | 75.3 |
| Wolayita | 68.7 |
| Gofa | 62.4 |

- Gamo Zone:** SMEs in the Gamo zone demonstrated the highest financial literacy level, with an average score of 75.3%. The relatively high financial literacy in this zone may be linked to greater access to financial education programs, higher SME density, and proximity to financial institutions. Business owners in Gamo have benefited from more frequent interactions with formal financial services, which may enhance their understanding and application of financial concepts.
- Wolayit Zone:** SMEs in Wolayit reported a moderate financial literacy score, with a mean of 68.7%. While this score is slightly below that of Gamo, it still reflects a fair level of financial understanding among SMEs. Limited but available access to financial literacy resources and institutions may contribute to these intermediate scores. Many SMEs in Wolayit have experience with budgeting, saving, and some forms of borrowing, although more complex financial concepts remain less understood.
- Gofa Zone:** SMEs in Gofa exhibited the lowest financial literacy level, with a mean score of 62.4%. This score indicates considerable challenges in financial knowledge and access to resources. Geographic isolation, fewer financial institutions, and limited financial literacy initiatives likely contribute to this lower literacy level. Consequently, SMEs in Gofa may face additional barriers in effectively utilizing financial services, potentially impacting their growth and sustainability.

Geographic Influence on Financial Service Utilization

The disparities in financial literacy across zones have implications for financial service utilization. SMEs in Gamo, with the highest financial literacy, also demonstrated a greater tendency to engage with financial services, including credit facilities, savings accounts, and financial planning services. In contrast, lower financial literacy levels in Gofa correlate with reduced use of formal financial services, suggesting a need for targeted interventions to improve access to financial education in this area.

Summary of Zonal Analysis

In summary, financial literacy among SMEs in Southern Ethiopia varies significantly across zones. Gamo zone leads in financial literacy, potentially due to greater institutional presence and resource availability, while Gofa lags, reflecting limited financial resources and educational outreach. Addressing these disparities through localized financial literacy programs could help improve financial inclusion and empower SMEs across all zones to contribute more effectively to regional economic growth.

Financial Literacy Levels across Sectors

The assessment of financial literacy across different sectors—manufacturing, services, construction, agro-processing, and trade—reveals notable differences influenced by each sector's financial demands and complexity.

Table 2 summarizes the financial literacy scores across sectors.

| Business type | Mean Financial Literacy Score (%) |
|----------------------|--|
| Manufacturing | 78.5 |
| Services | 64.5 |
| Construction | 69.2 |
| Agro-processing | 73.8 |
| Trade | 65.9 |

- **Manufacturing Sector:** SMEs in the manufacturing sector exhibited the highest financial literacy levels, with a mean score of 78.5%. This higher score likely reflects the financial management complexities typical in manufacturing, such as cost accounting, procurement, production planning, and investment in machinery. These enterprises are generally more proactive in seeking financial knowledge to manage their resources effectively.
- **Agro-Processing Sector:** Agro-processing SMEs followed closely behind manufacturing with an average financial literacy score of 73.8%. Financial literacy is crucial in this sector for understanding supply chain management, price fluctuation, and financing for equipment and raw materials. The need to manage seasonal production cycles and respond to market demands likely drives higher financial literacy among these SMEs.
- **Construction Sector:** Construction SMEs reported a moderate financial literacy level, with a mean score of 69.2%. The financial skills required in this sector include budgeting for projects, managing cash flows during varying project phases, and navigating credit for supplies. However, the

complexity of financial management in construction may be limited to larger projects, and smaller construction businesses may not have the same level of financial knowledge.

- **Trade Sector:** SMEs in the trade sector showed a mean financial literacy score of 65.9%. In trade, the financial literacy skills required focus on inventory management, pricing strategies, and managing credit sales. However, many trade-based SMEs are informal or micro-enterprises, potentially limiting their access to financial literacy programs, which may contribute to lower financial literacy scores.
- **Service Sector:** SMEs in the service sector reported the lowest financial literacy level, with a mean score of 64.5%. Service businesses typically have simpler financial structures with less need for inventory management and credit purchases. Many service-based SMEs operate on a smaller scale and rely on informal financial practices, resulting in lower financial literacy levels.

Sectoral Influence on Financial Service Utilization

The sectoral differences in financial literacy levels appear to have a direct impact on the extent of financial service utilization. Manufacturing and agro-processing SMEs, which scored the highest in financial literacy, were also more likely to use formal financial services, such as loans, business savings accounts, and investment options, to support business growth. Conversely, service and trade SMEs, with lower financial literacy levels, reported less engagement with formal financial services.

Summary of Sectoral Analysis

This analysis shows that financial literacy levels among SMEs vary significantly across sectors. Manufacturing and agro-processing SMEs, which require more complex financial skills, scored the highest in financial literacy. In contrast, the trade and service sectors, with less demanding financial management needs, reported lower literacy levels. This suggests that sector-specific financial literacy training programs may help bridge these gaps and support broader financial inclusion and economic growth across all SME sectors.

Discussion

1. Comparison of Results with Other Studies

The findings of this study indicate significant variations in financial literacy levels among SMEs across the Gamo, Wolayit, and Gofa zones of Southern Ethiopia, which aligns with previous research highlighting regional disparities in financial literacy. For instance, Lusardi and Mitchell (2014) found that individuals in different geographic locations often exhibit varying levels of financial literacy, influenced by factors such as access to education, economic conditions, and cultural attitudes toward financial management. Similarly, Aterido et al. (2013)

noted that financial literacy is not uniformly distributed across sectors, with industries that require more complex financial decision-making, such as manufacturing, often exhibiting higher literacy levels.

The higher financial literacy scores observed in the Gamo zone can be compared with studies conducted in urban areas, where better access to financial education and resources tends to lead to improved financial knowledge. For instance, the World Bank (2020) reported that SMEs in urban regions of Ethiopia demonstrate higher engagement with financial institutions and greater financial literacy than their rural counterparts. In this context, the findings underscore the critical need for targeted financial education initiatives in areas like Gofa, where SMEs face significant challenges in accessing financial resources.

Implications for SME Development

The implications of the study's findings are multifaceted and critical for the sustainable development of SMEs in Southern Ethiopia.

a. Targeted Financial Education Programs

The disparities in financial literacy levels across zones and sectors highlight the need for tailored financial education programs. Policymakers and financial institutions should consider implementing localized training initiatives that address specific financial literacy gaps, particularly in lower-performing zones and sectors like trade and services. These programs could focus on essential financial management skills, including budgeting, cash flow management, and understanding financial products.

b. Enhancing Access to Financial Services

Given the strong positive correlation between financial literacy and the utilization of financial services, enhancing financial literacy can significantly improve SMEs' access to formal financing options. Financial institutions should consider designing products that cater to the unique needs of SMEs in different sectors. Additionally, fostering partnerships between financial institutions and local organizations can help create awareness about available financial services and encourage SMEs to engage with them.

c. Supporting Entrepreneurial Development

Improving financial literacy among entrepreneurs can lead to better decision-making, reduced financial risk, and increased business performance. Empowering entrepreneurs with financial knowledge can also enhance their ability to innovate and adapt to market changes. As indicated by Menkhoff et al. (2017), financially literate entrepreneurs are more likely to invest in growth opportunities, thus contributing to job creation and economic resilience in their communities.

d. Gender Considerations

The demographic analysis revealed that financial literacy levels were influenced by educational qualifications and age, indicating a potential need to address gender disparities in financial literacy. Women entrepreneurs often face unique challenges in accessing financial education and services. Therefore, gender-sensitive approaches should be incorporated into financial literacy programs to ensure equitable access and empower women in the entrepreneurial landscape.

Overall, the findings of this study emphasize the critical role of financial literacy in fostering the growth and sustainability of SMEs in Southern Ethiopia. By addressing the identified disparities and implementing targeted interventions, stakeholders can empower SMEs to enhance their financial management practices, ultimately contributing to broader economic development in the region.

Conclusion

Summary of Findings

This study aimed to assess the financial literacy levels of small and medium enterprises (SMEs) across three zones in Southern Ethiopia—Gamo, Wolayita, and Gofa. The findings revealed significant variations in financial literacy levels among the zones, with the Gamo zone demonstrating the highest mean financial literacy score (75.3), followed by Wolayita (68.7) and Gofa (62.4). Additionally, differences in financial literacy levels were observed across various sectors, with manufacturing SMEs exhibiting the highest scores (78.5), while the trade and services sectors had notably lower scores (65.9 and 64.5, respectively).

The study also found a strong positive correlation ($r = 0.65$, $p < 0.01$) between financial literacy and the utilization of financial services, indicating that SMEs with higher financial literacy levels were more likely to engage with formal financial institutions. Furthermore, demographic factors such as education level and age were associated with higher financial literacy, underscoring the need for targeted interventions to address the unique challenges faced by different entrepreneur groups.

2. Limitations

While the findings provide valuable insights into the financial literacy landscape among SMEs in Southern Ethiopia, several limitations should be acknowledged. The cross-sectional design of the study limits the ability to establish causal relationships between financial literacy and business outcomes. Additionally, the reliance on self-reported data may introduce response bias, as participants may overstate their financial knowledge or skills. Furthermore, the study focused

solely on quantitative data; thus, qualitative insights into the entrepreneurs' experiences and challenges related to financial literacy were not explored.

3. Recommendations

Based on the findings and limitations of this study, the following recommendations are proposed:

- **Implement Targeted Financial Literacy Programs:** Policymakers and financial institutions should develop localized financial education initiatives tailored to the specific needs of SMEs in different zones and sectors. This could involve workshops, seminars, and training programs focused on essential financial management skills.
- **Enhance Access to Financial Services:** Financial institutions should consider creating products and services that cater to the unique needs of SMEs, especially in underperforming zones like Gofa. Establishing partnerships with local organizations can help increase awareness and access to these services.
- **Promote Gender-Sensitive Approaches:** To address gender disparities in financial literacy, it is crucial to implement gender-sensitive strategies that empower women entrepreneurs through targeted financial education and access to resources.
- **Conduct Longitudinal Studies:** Future research should adopt a longitudinal design to explore the causal relationships between financial literacy and SME performance over time. Additionally, qualitative studies could provide deeper insights into the barriers and challenges faced by entrepreneurs in achieving financial literacy.

4. Final Thoughts

In conclusion, enhancing financial literacy among SMEs in Southern Ethiopia is vital for promoting their growth, sustainability, and overall contribution to the economy. By addressing the identified gaps and implementing strategic interventions, stakeholders can empower SMEs to navigate the financial landscape effectively, fostering economic development in the region.

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