INNOVATIONS

# The impact of business environment on firm growth: an explanatory Study of micro and small enterprises in three cities of Oromia, Ethiopia

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**Abstract**

Small businesses are critical to attaining the Sustainable Development Goals (SDGs), including eradicating poverty and achieving gender equality. They contribute to local economies by generating revenue and creating jobs. The Ethiopian Government's current MSE Development Strategy aims to foster equitable development, raise incomes, and reduce poverty by increasing job opportunities. However, several reasons hinder the growth of small firms, making it difficult to reach the goal. The study's main goal is to discover the factors in the business environment that influence the growth of micro and small firms in three cities in Ethiopia's Oromia region. Two hundred eighty-six(286) enterprises are chosen from the three cities using a cluster sample technique, and data is collected using schedules. The study employs both univariate and bivariate data analysis approaches. The frequency table, percentages, and the meanare used to present the collected data. An independent sample t-test is used to determinewhether there is a significant difference between variousenterprises groups. The study's findings revealed that the growth rate of employment in micro and small enterprises in the three cities is significantlydetermined by the demand for products/services of enterprises and the supply of raw materials. Manufacturing enterprises have a higher raw material supply problem than enterprises in other sectors. Entrepreneurial role models and market competitionalso impactthe employment growth rate in micro and small enterprises in the three cities.On the other hand, power supply has no effect on the growth rate of employment in micro and small businesses in the three cities.

**Keywords:** 1.Enterprise 2.Business environment 3.Employment 4.Employment growth rate

## I. Introduction

### Background of the Study

Entrepreneurship is an important tool for achieving the Sustainable Development Goals (SDGs), including poverty eradication and gender equality. It helps local economies by creating jobs, raising revenue, fostering equity, and stimulating innovation (Muturi, 2015). Entrepreneurship promotes equity by providing lucrative possibilities to

underserved groups such as women, the disabled, and unemployed young people. As a result, entrepreneurship is becoming more widely recognized to attain development goals (Mwiathi and Wanjiru, 2020).

According to Pinto (2019), the Ethiopian economy was state-led for long, and the private sector was virtually non-existent. Although the former Handicraft and Small-Scale Development Agency (HASIDA) was responsible for supporting handicrafts and small-scale industries, particularly the development of socialist cooperatives, with branch offices in major towns and provinces across the country, there were no state policies to support the MSME sector. Since then, the Government of Ethiopia has recognized the importance of the Micro and Small Enterprise (MSEs) sector, particularly in terms of boosting employment, which is the most pressing economic priority. Several policy frameworks relate to MSE growth today, the most important of which is the Micro and Small Enterprise (MSE)Development Strategy. In 1997, the Government of Ethiopia created the first MSEs Development Strategy, which included establishing organizations to carry it out. In 2011, the current MSE Strategy was changed to address some apparent flaws, such as a lack of a strategy, resources, monitoring and evaluation, coordination, etc.

The Government of Ethiopia's current MSE Development Strategy aims to provide a competitive and convenient platform for the country's industrial development. Through employment creation, the plan strives to encourage equitable development, increase incomes, and reduce poverty. Furthermore, the country's micro and small enterprise development policy aims to foster a sustainable MSE sector to facilitate economic growth and provide the groundwork for industrial development (MoUDC, 2012). Human capital and technology development policy, industrial extension services through TVET Centres, access to finance, access to capital and working premises (affordable premises, etc.), market development (outsourcing, franchising, markets, bazaars, etc.), One-stop Service Policy are the major Government intervention areas.

**Literature Review**

MSMEs face a variety of challenges. The requirement of credit for day-to-day operations remains a significant impediment. Some of the more well-known challenges associated with the industry include marketing bottlenecks, raw material scarcity, infrastructure deficiencies, competition from large enterprises, and managerial issues. According to Michael (2015), in India, poor artisans, weavers, and household unit owners, among others, have trouble accessing the market. Most MSEs, according to the author, lack the financial resources to do market research and are unable to implement design and technological changes to stay up with market needs, resulting in a lack of market for their products/services. Due to a lack of market intelligence, intermediaries take advantage of and exploit poor artisans and weavers by paying a low price for their goods and then selling them on the worldwide market at exorbitant costs.

MSMEs have various obstacles, including limited access to credit, according to the Deloitte Kenya Economic Outlook (2016). Due to their inability to attract investors and their lack of creditworthiness, there is a gap in the small business financing industry. However, according to Kariuki and Omwenga (2017), MSEs' ability to obtain funding is critical to their success. Mwiathi and Wanjiru (2020) found that despite the Government's efforts to improve equity among socially disadvantaged groups such as women, the disabled, and unemployed young in India, uptake of funds is low due to unfavorable lending circumstances, resulting in a financing gap. Furthermore, according to Ogeta (2016), high-interest rates and collateral requirements imposed by banking institutions increased the cost of borrowing, discouraging small business owners from taking out loans. MSMEs in India confront a variety of challengesbut none is more challenging than obtaining short- and long-term funding.

Saini (2014) stated that models of equilibrium credit rationing that revealmoral hazard' and 'adverse selection difficulties' indicate that MSMEs are vulnerable due to a lack of information. That is, the information gap between outsiders and MSMEs is widening, making external financing increasingly difficult to get. MSMEs with the potential to invest in positive future projects may be prevented from doing so because potential external finance providers are unable to quickly

confirm that they have access to a quality project (adverse selection problems) or have the means to verify that project funds will not be diverted to another venture (moral hazard).

Access to raw materials affects the operational efficiency of Small And Medium Enterprises (SMEs) in the manufacturing sector in India. After access to finance, access to raw material was recognized by 91 percent of SMEs as the second most difficult issue. According to the survey's core results, obtaining raw materials at competitive costs is a serious difficulty for large number of SMEs. Particularly, SMEs in the manufacturing industry to remain competitive, they must keep raw material costs under control. Furthermore, growing costs make it harder for SMEs to compete with large corporations, which benefit from bulk-purchasing discounts. Overall, these difficulties jeopardize the long-term viability of small firms.

Exposure to role models is thought to have a favorable impact on entrepreneurial ambitions by offering specific instruction and support or by creating an environment that encourages entrepreneurial action (BarNir et al. 2011). Previous research has shown two significant advantages that the existence of entrepreneurial role models provides to aspiring entrepreneurs in a particular society (Wyrwich et. al, 2015). According to the authors, having entrepreneurial role models in society gives people who want to start a business the opportunity to learn about entrepreneurial actions and abilities. The presence of successful entrepreneurs in a society, in particular, reduces the anxiety that others who want to start a firm have about doing so and helps them acquire vital business knowledge and skills. As a result, seeing successful entrepreneurs reveals to those interested in entrepreneurship the ability to arrange the resources and activities required to start and run a business, as well as increasing individual self-confidence. Second, the presence of entrepreneurial role models in a society will have a psychological impact on people who aspire to be entrepreneurs, in addition to supplying crucial business information and imparting vital business skills. In relation to this, the presence of entrepreneurial role models encourages future entrepreneurs to consider entrepreneurship as a viable career option after watching someone with whom they interact is doing so.

The Ethiopian government provides direct policy support to MSEs in addition to providing a conducive business climate for their growth (Beharu et al., 2014). Access to markets, access to finance, access to industrial extension services, access to training, and technological help are all examples of direct state support to the sector. However, according to the authors, one of the greatest obstacles to MSE expansion in Ethiopia is access to market. The government has been attempting to alleviate the market problem of MSEs by purchasing items directly from enterprises and connecting them with big and medium businesses in the market as sub-contractors and input suppliers. The provision of financial support is another critical area of government involvement to boost MSEs. In this context, the government has drafted a national microcredit and savings directive aimed at easing the financial constraints faced by MSEs in the country. However, financial problems continue to be a challenge for MSEs in the country. Working space is another important component in MSE growth, though it remains a crucial concern for MSEs, despite the government's substantial construction of working spaces for them in major cities and towns.

Several studies arebeing conducted in developed and developing countries to determine the different aspects of the business environment that influence firm growth. However, the number of studies on the subject in the state (Oromia) and the three cities, in particular, is limited. Due to a shortage of empirical studies, policymakers tend to attribute micro and small business growth problems to other factors (owner/manager and organizational) than the business environment. As a result, recognizing barriers in the business environment is critical, particularly for policymakers to work on and provide solutions. This research aims to close this gap by finding the factors in the business environment that have a substantial impact on the rate of employment growth in micro and small businesses in the three cities.

**Study Objective**

The study's major goal is to identify characteristics of the business environment that substantially impact the rate of employment growth in micro and small businesses in the three cities. The study particularly aims to:

- Characterize the business environment of micro and small businesses in the three cities; and
- Identify the factors in the business environment that have a substantial impact on the rate of employment growth in micro and small businesses in the three cities.
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**Hypothesis**

The study mainly emphasizes on adequacy of demand and supply, access to credit, market competition, impact of entrepreneurial role models and supply of power as major business environment factors. Accordingly, the study is designed to test the following hypothesis:

- Hypothesis 1: $H_o$ = There is no significant difference in rate of growth of employment between micro and small enterprises with sufficient demand for their product/service and enterprises with no adequate demand for their product/service in the three cities.
- Hypothesis 2: $H_o$ = There is no significant difference in rateof growth of employment between micro and small enterprises with the plentysupply of raw material and enterprises with no plentysupply of raw material in the three cities.
- Hypothesis 3: $H_o$ = There is no significant difference in employment growth rate between micro and small enterprises with easy access to credit and enterprises with no easy access to credit in the three cities.
- Hypothesis 4: $H_o$ = There is no significant difference in the rate of growth of employment between micro and small enterpriseswhose owners/managers start business influenced by a successful entrepreneurial role modeland enterprises whose owners/managers have no successful entrepreneurial role model in the three cities.
- Hypothesis 5: $H_o$ = There is no significant difference in the employment growth rate between micro and small enterprises with an adequatesupply of power and enterprises with no goodsupply of power in the three cities.

**Method**

Data collection for the study is done using schedules. This form of data gathering is similar to questionnaire data collection, except that schedules are filled out by enumerators who are particularly hired for the job. These enumerators, with the schedules, visit respondents, ask them questions in the order they are listed and record their answers in the appropriate space. Enumerators explain the investigation's goals and objectives and help any respondent grasp the purposeof each question and the definition or notion of difficult terms (Kothari, 2004). Hence, three enumerators are hired and made to collect the data required for the study. The enumerators are given anorientation on the purpose of the study and an explanation ofthe questions included in the schedule by the researcher.

Cluster sampling is used to choose sample responders from the three cities. The primary sampling unit (the initial stage of the sampling operation) in cluster sampling is not the population units to be sampled but rather groupings of those units (Bryman, 2012). Three sub-cities are chosen from each city using a simple random probability sampling technique. A systematic random sample technique is used to select micro and small businesses from each specified sub-city. According to Kothari (2004), the most basic type of probability sample is the random sample because each population unit has an equal chance of being included in the sample. One-Stop Service Centers in the sub-cities provide the list of micro and small enterprises used to draw respondents. One-Stop Service Centers are government entities created at the sub-city level to provide various services, including registration.

The data analysis method employs both univariate and bivariate data analysis approaches. The research data is organized and presented using the univariate (descriptive statistics) technique. The percentages, frequency tables, and mean are used to portray the research data. Under the bivariate data analysis technique, the independent samples t-test is employed. The independent samples t-test is used to evaluate if there is a significant difference among various groups with respect to the employment growth rate in micro and small enterprises in the three cities.

The independent sample t-test uses a categorical independent variable and a continuous dependent variable. Several

characteristics in the business environment are consideredindependent variables, including demand availability, supply sufficiency, competition, accessto credit, presence of entrepreneurial role models, and power supply. The dependent variable is the rate of employment growth. The independent samples t-test is used to examine employment growth rates among different groups of independent variables (for example, firms with sufficient demand for their product/service vs. those with insufficient demand). Factors in the business environment are dichotomous category /dummy/ variables, while the rate of employment growth is a continuous/scale variable.

Business growth, according to Belay F. (2012), can be judged by three indicators: increase in employment, rise in turnover/sales volume, and profit amount. Employment growth is used as a measure of micro and small business growth in this study. The Evans (1986) formula cited in Yimesgen (2019)is used to compute the rate of increase of employment in micro and small firms, as The following is the formula:

$$gr = \frac{St' - St}{Ea}$$

Where:

- $gr$ = rate of growth of employment,
- St′ = current number of employees,
- St =startup number employees, and
- Ea = enterprise's age.

**Response Rate**

A total of 286 micro and small enterprises were included in the research. This figure represents 85.4 percent of the total number of micro and small firms that will be investigated (342). 43.4 percent, 26.2 percent, and 30.4 percent of the total enterprises in the survey are from Adama, Bushoftu, and Shashemene, respectively. Fifty (50) firms were left out of the study, some because their owners/managers failed to react on time to the timetable, and others because they had already closed their doors during the data collection period. Six (6) micro and small enterprises with outlying values are deleted from the data setto maintain the data's normal distribution.

Micro and small business owners and managers are approached to obtain their responses to the study's questions. Where a group of people owns enterprises, the managers of the businesses are approached as respondents. However, when a single person owns a business, the ownerresponds to the research questions. As a result, 194 (67.8%) business managers and 92 (32.2%) business owners took part in the research.

**Characteristics of Enterprises**

152 (53.1%) of the 286 businesses are micro-businesses, with the remaining 134 (46.9%) being small businesses. The average age of the businesses is 3.72 years; the youngest is two years old, and the oldest is seven years old. The companies in the study come from a variety of industries. According to the responses of the owners/managers of the businesses, 92 (32.2%) are service rendering businesses, 72 (25.2%) are manufacturing businesses, 70 (24.5%) are merchandising businesses, 28 (9.8%) are construction businesses, and the remaining 20 (6.9%) are farm businesses.

The annual employment growth rate of the enterprises is calculated by dividing the difference between the current and beginning number of employees by the age of the business. The annual rate of job growth in the analyzed businesses ranges from – 0.66 to 2.67. With a standard deviation of 0.72, the mean yearly employment growth rate is 0.60. In certain enterprises, the annual employment growth rate is negative or nil (survivalist firms), whereas in others, it is positive (growth-oriented enterprises). While 122 (42.7%) of businesses are survivalists (with no or negative employment growth), the remaining 164 (57.3%) are growth-oriented businesses (with a positive employment growth rate).

**Table 1: Distribution of Enterprises by Business Type**

| No | Business Type | Count | Percentage | Remark |
|---|---|---|---|---|
| 1 | Service | 92 | 32.2 | |
| 2 | Manufacturing | 72 | 25.2 | |
| 3 | Merchandizing | 70 | 24.5 | |
| 4 | Construction | 28 | 9.8 | |
| 5 | Agriculture | 20 | 6.9 | |
| 6 | Others | 4 | 1.4 | |
| | **Total** | **286** | **100** | |

**Source: Survey result, 2020/21**

Some business sectors have a higher pace of job growth than others. Agriculture-related firms have the highest average annual rate of job growth, followed by manufacturing businesses. The average job growth rate in agricultural businesses is 1.533 percent, whereas it is 0.933 percent in manufacturing businesses. The mean employment growth rates for service, merchandising, and construction businesses are 0.336, 0.397, and 0.533, respectively.

The firms' initial capital ranges from Birr 3000 to Birr 500,000. According to the descriptive statistics, the average startup capital of the businesses is Birr 26,720. The companies' current capital ranges from Birr 5000 to Birr 1,500,000. The firms' average current capital is Birr 421,020. The number of employees at the start of the businesses ranged from one to ten, with a mean of 3.37 and a standard deviation of 1.77. The current staff count ranges from 1 to 14, with an average of 5.5.

**Characteristics of the Business Environment**

The study attempted to explore some key aspects of business settings that may impact the growth of businesses. The study looked at the adequacy of demand, the availability of a sufficient supply of raw materials, the intensity of competition, credit availability, the presence of entrepreneurial role models, and power supply.

When asked about the adequacy of demand for their product/service, mostmicro and small enterprise owners/managersreplied that there is a goodmarket for their product/service.Of the 286 enterprise owners/managers that responded to the question, 208 (71.3%) indicated that there is enough demand for their enterprises' products/services. However, 84 (28.7%) owners/managers denied that the demand for their enterprises' products/serviceswas sufficient. The average employment growth rate in businesses with adequate demand for their product or service was 0.68, while it was 0.42 in enterprises with insufficient demand. The independent samples t-test result revealed a significant difference (*P*-value <0.01) in the rate of employment growth between enterprises with sufficient demand for their product/service and enterprises with insufficient demand for their product/service.

Participants in the survey were asked if there isan adequate supply of raw material for the normal operation of their business. Nearly 60% (172) of the owners/managers pointed out that there is sufficient raw material supply, whereas nearly 40% (114) indicated no insufficient raw material supply. The mean employment growth rate in firms with enough raw material supply is 0.53, but it is 0.71 in enterprises that have reported a scarcity of raw material. The independent samples t-test result revealed a significant difference (*P*–value <0.01) in employment growth rate between enterprises with enough raw material supply and enterprises with not enough raw material supply.

The proportion of manufacturing firms reporting a shortage of raw materials is higher than the proportion reporting otherwise. Roughly 58% of the manufacturing enterprises reported raw materialshortages. The remaining 41.7% of manufacturing businesses stated that they do not have a raw material shortage. On the other hand, 80% of agricultural enterprises, 77.1% of merchandisingenterprises, 71.4% of construction enterprises, and 56.5% of service enterprisesindicated that they had no supply issues.

Regarding competition, 52 (19.5%) of the 266 enterprises owners/managers that responded to the question stated that competition is high, while 24 (9%) noted that competition is weak. In this regard, a substantial percentage of business owners/managers, 190 (71.4%), felt moderate competition. The investigation findings revealed that the rate of job growth is high in businesses that demonstrate that they operate in a high competition market. In firms that work in markets with strong, moderate, and mild competition, the mean employment growth rate is 1.0, 0.53, and 0.47, respectively. Furthermore, the independent sample t-test result revealed a significant difference (P-value 0.01) in the employment growth rate between firms operating under high competition and enterprises operating under moderate competition.

Another issue identified by business owners/managers who took part in the study is loan availability. The question was answered by a total of 282 business owners/managers. 112 (39.7%) of the total business owners/managers who responded said they could easily secure a loan to expand their business. On the other hand, 170 (60.3 percent) business owners stated that obtaining a loan for business expansion is difficult. The mean employment growth rate in firms that reported access to credit as an easy task is 0.56, compared to 0.63 in enterprises that reported access to credit as a difficult attempt. The findings reveal that it is difficult for well-performing firms (in terms of employment growth rate) in the three cities to obtain the credit they require for business expansion. The variation in loan access could be, perhaps, because Oromia Credit and Saving Share Company, a microfinance organization well-known for providing loans to micro and small businesses in the three cities and the region, focuses on providing credit to startups than existing enterprisesthat seek finance for business expansion purpose.

In terms of the presence of entrepreneurial role models, the majority of enterprise owners/managers who responded to the question said that successful entrepreneurs in their community motivated them to start a firm. 242 (84.6%) of the 286 respondents who replied to the question stated that a successful business owner in their community motivated them to start a business. In comparison, 44 (15.4%) enterprise owners/managers rejected that a successful business owner in their community influenced them to start a business. The average yearly employment growth rate in enterprises whose owners/managers start a business beinginfluenced by a successful entrepreneur is 0.65. However, the average rate of job growth in enterprises whose owners/managers start a business without the influence of a successful entrepreneur is 0.29. In the three cities, there is a significant difference in the rate of growth of employment between enterprises whose owners/managers start a business through the influence of a successful entrepreneur and enterprises whose owners/managers start a business without being influenced by a successful entrepreneur (*P*-value< 0.01).

Finally, enterprise owners/managers were asked regarding power supply. In this regard, 160 (55.9%) enterprise owners/managers indicateda sufficientpower supply, while 126 (44.1%) reporteda power supply shortage. The pace of employment growth is higher in businesses that report a shortage of power supply than in enterprises that report enough supply power. The job growth rate in enterpriseswith enough power supply is 0.63, whereas it is 0.58 in enterpriseswith enough power supply. The difference in rates of growth of employment between the two groups is not statistically significant (P-value = 0.521).

**Conclusion**

Service provisionenterprises make up the majority of the sample, followed by manufacturing businesses. Agricultural enterprises, on the other hand, account for the smallest percentage. Although most organizations have a positive employment growth rate, a considerable number of micro and small businesses in the sample havezero or less than zero (negative) rate of growth of employment. Agricultural enterprises have the highest average annual rate of job growth, followed by manufacturing businesses. In terms of yearly employment growth, services enterprises are the lowest.

The employment growth rate is much higher in businesses with an adequate market for their product/service than enterprises with a market problem. Furthermore, the job growth rate in firms with an adequate supply of raw material is much higher than in enterprises with trouble obtaining a sufficient supply. In comparison to other industries,

manufacturing businesses experience a significant lack of raw materials. In the three cities, the employment growth rate is much higher in firms operating in a market with strong competition than in enterprises operating in a market with moderate competition. However, there is no discernible difference in the employment growth rate between businesses that can readily acquire a loan and those that cannot. Finally, the employment growth rate in firms with sufficient power supply and enterprises with a power supply deficiency is similar.

Finance institutions that provide loans to micro and small enterprises in the three cities should pay attention to businesses that need finance to expand their business. In the past, these institutions (particularly the erstwhile Oromia Saving and Credit Association) primarily provided funding to startups rather than enterprises looking to expand. The respective cities' industry and enterprise development departments must collaborate closely with the enterprises to tackle market and supply problems. Given the supply problem of manufacturing firms, special attention should be paid.

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