Documento de Trabalho nº59, CEsA, Lisboa, 2000

The Dilemma of Small Business in Mozambique:

The Reason to Be is the Reason not to Prosper

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The Dilemma of Small Business in Mozambique: The Reason to Be is the Reason not to Prosper

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0. Introduction

One of the main problems of Mozambican small businesses is that they have some characteristics on which, on the one hand, they depend to survive, but which, on the other hand, make it impossible - or at least difficult - for them to prosper and grow. Most small businesses are informal, unregistered, have no bank account and are usually temporary activities. They help to diversify the family income and are organised in local circuits.

The first part of this paper provides a review of the literature on small businesses in Africa, particularly in Mozambique, namely its characteristics and possible reasons to be. The second part highlights the results of several interviews with small-business entrepreneurs in Sofala/Mozambique.

1. The Importance of Mozambican Small Businesses

A vast portion of the economic activity in Mozambique consists of small businesses. Moreover, it is often either informal or unrecorded in official sources. The accuracy of the statistical coverage is poor and uneven. Recent calculations of the economic contribution of the informal sector, by the Instituto Nacional de Estatistica (INE) and the Italian Government Co-operation Agency suggest that the real GDP is underestimated by some 79 %. (EIU 1998, p. 13). Pinto de Abreu, from the Central Bank in Mozambique, using a monetarist approach, has estimated that the informal sector accounts for at least 33 % of the Mozambican GNP (Pinto de Abreu 1996). In the second largest city in Mozambique, Beira, we estimate that at least 60 % of the firms are informal businesses (Navaia, E.; Kaufmann, F. 1999).

The latest “Industrial Strategy Policy” of the Mozambican Government has officially recognised the importance of the small businesses. It has also stressed the need for the “inclusion of the informal sector” (República de Moçambique, 1997, p.32).

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2. General Key Characteristics of Mozambican Small Firms

2.1 Definition

In quantitative terms, as an upper limit, firms are usually no longer defined as "micro", or "small", when they have more than ten employees (Vletter, F. de, 1996, p.4). This quite broad definition implies that small firms can be both formal and informal. In Mozambique, we find the so-called "empresas informais" and the "empresas registadas (3ª categoria)" which fulfil these criteria. The "third category" firms have up to ten employees and are administered by the local authorities, just like the "informal businesses", which have to pay fees to the city council.

Small businesses vary a lot: they are actively engaged in production (agricultural, non-agricultural, craftsmen, petty producers), trade (food, drinks, agricultural products, manufactured goods, firewood etc.) and/or many service-related sectors (repair, hair-cutting, food stalls, etc.).

2.2 Key Characteristics of Small Businesses

2.2.1 Labour intensity

The empirical literature suggests that an increase in the firm size is associated with a decrease in the labour to capital ratio (Page, J./Steel,W., 1984). Small firms, especially informal businesses, have no access to institutional credit and are often unable to pay their workers the legal minimum. The high labour intensity within small firms may reflect the biased factor costs.

Small firms usually use technologies that are less modern and less capital-intensive than those used by large firms (Billetoft 1997, p.16). It is questionable whether small firms consider different "production functions" at all, or just adapt to the relative prices of the various production factors.

2.2.2 Dependence upon infrastructure

Among the various small firms, there are obvious differences in the degree of dependence upon infrastructure. Still, generally speaking, small firms often provide their own power supply and can more easily adapt to different types of location or shelter. That is why a higher proportion of small firms is found in rural areas, villages and small towns, whereas medium and large-sized firms tend to be situated in cities with a certain level of infrastructure.

2.2.3 Entrepreneurship

Small firms are not only the fastest growing sector in Africa (Vletter de, 1996) - they are also considered an outlet for indigenous entrepreneurship (Page; Steel, 1984, p.22). Usually, the owners of African small firms come from within the small firm sector itself. Only a few have learned their skills in larger firms. We can assume that the “bottom-up approach” dominates the formation of small-sized firms (no out-sourcing).

We must also keep in mind that there is still a kind of dual economic structure in most African countries like Mozambique (Todaro 1997/Biggs et al. 1999, p. 8). On the one hand, the country has inherited a number of large and relatively modern enterprises from the days of colonial rule and, on the other hand, we find indigenous firms that mainly use old production techniques. This sort of duality still remains across many sectors and regions. It is even being reinforced by the ongoing privatisations, which rely mainly on foreign capital and FDI (Chissancho 1998).

The level of formal education is modest. Most skills have been acquired through traditional apprenticeship or within other small firms (Billetoft 1997). Nevertheless, most small businessmen lack extensive know-how and training in financial management, marketing, business organisation, cost assessment, etc.

2.2.4 Sources of Finance

Most small firms do not have access to formal financial institutions. Even if they did, the often overvalued real interest rates would discourage investments anyway (UNDP 1998, p.63). Hence, investments are financed by personal risk capital like savings, loans, assistance from relatives, pensions or the selling of an asset. Typically, the initial capital for a start-up is low (< 100 US $) and the capital stock used is also modest. Nevertheless, the growing number of NGO-Micro-Enterprise financing schemes provides, at least for some small firms, new ways of financing (Vletter de, 1997).

2.2.5 Demand

It has been frequently pointed out that small firms provide many of the consumer goods demanded by the lower-income population. However, some of them are more flexible and more able to shift away from inferior goods and operate in more segmented markets (Billetoft 1997, p. 37).

Empirical studies indicate that there is a strong positive correlation between local income and the demand for small-scale products (Liedholm 1992, p. 189). That is why small firms are often set up near income-generating large businesses, like the Mozambican sugar industry.

In spite of some negative aspects, such as crime or the lack of hygiene, informal markets are appreciated by their customers because of their nearness and their ability to adjust quantities to the purchasing ability. Besides, informal businesses are often cheaper and have more flexible working hours (Vletter de, 1996, p.36; Fungulane 1999).

3. Reasons for the Existence of Small Firms

3.1 General Observations

The firm population is characterised by great size heterogeneity. The literature on industrial organisation provides many explanations for the existing firm sizes, which, at least partly, are of a complementary kind (Fafchamps 1994). Research on Europe found out that, even in that continent, the average firm size varies from country to country and from sector to sector. The firm size may depend on the country size (markets), technology, culture, etc (Icks; Kaufmann; Menke 1997). Although there aren't any precise data available, especially for Africa (Liedholm 1992), it is clear that the average firm size in the developing countries is much smaller than in the developed countries (Kaufmann; Tesfayohannes 1997).

3.2 Minimum Efficient Size

Firms of any size can co-exist above a certain minimum efficient size, dictated by the state of the art technology. We must also take into consideration the effects of the market size and the transportation costs. The small size of the market may restrict the firm size. In the presence of large transportation costs, it may be profitable to produce below what would be the minimum efficient size from the point of view of technology. Given the poor road infrastructure in Mozambique, this is especially true for rural areas.

In the industries for which mass production techniques have not been developed or adapted to local preferences, small-scale technology is the state of the art technology. Start-up costs are low, often just consisting of vocational training. Because they are determined by local preferences, there is no industrialised competitor and no transferable mechanised technology. Local production provides cheap, low-quality goods for poor consumers. Anyway, personal services often fail to generate returns to scale. But whenever the market size increases or the market niches (artificial or natural) fade away (e.g. the building of a road that can be used during the rain season), it is likely that some mechanised modes of production are invented. That means that small firms have to adapt or, more likely, that the production may fall into the hands of larger firms.

3.3 Transaction Costs and Market Failures

Along with production costs, transaction costs are very important (Williamson 1985). Transaction costs are the costs due to information problems and market failures (e.g. information asymmetries). Addressing these issues is costly and requires special governance structures, contractual designs, incentive schemes, information systems, bonding, etc., which try to minimise the transaction costs associated with the economic activities (Gibson 1999). Along with the production cost structures, it is the transaction cost structures that define the optimal firm size. For example, this explains why some transactions (economic activities) are internalised by a firm and others are out-sourced to the market. The sum of the production cost structure and the transaction cost structure must be efficient and, thus, explains the existing firm sizes (Kaufmann 1996).

The interaction between production technology, information transfer costs and incentive problems can lead to a variety of governance structures and, hence, a variety of firm sizes in the same market. The concept of "transaction costs" therefore helps to explain the existence of small firms. Sure enough, it is difficult to measure the transaction costs and the market failures and to estimate whether they are more favourable to smaller or larger firms (Kaufmann 1997a). Some elements show that small firms may have certain advantages when it comes to addressing transaction costs.

3.3.1 Labour

Because of the moral hazard problems in labour contracts, it is difficult for employers to design working relations/contracts that motivate workers to be reliable and dynamic. That especially holds in the case of sub-Saharan patronage systems. Self-employment in small firms makes entrepreneurs the residual claimants of the fruits of their work, thus providing better motivation. In addition to that, small firms often have access to family manpower. That means that there is less danger of moral hazard, shirking etc., that information flows more freely and that the fixed costs of the business can be reduced.

Furthermore, small firms, which, to a great extent, consist of informal businesses, attract young, inexperienced people, who could not qualify for more formal education. They are paid low wages, sometimes below the legal minimum.

3.3.2 Capital

Due to the information asymmetries, capital markets suffer from market failures caused by moral hazard and adverse selection. Organised capital markets – such as stock markets – try to overcome and reduce those problems. In Africa, either these markets don't exist, or they are not available to small and medium sized firms. Even in Europe, this is a serious issue (Kaufmann 1997b).

Hence, small investors have no chance of investing venture capital (high risk/return level). Consequently, African small firms are a possible outlet for small amounts of private venture capital. Small investors (private savings) can either create their own firm or finance the enterprises of close friends or relatives. Their skills and performance can be more easily monitored, meaning that the problems arising from information asymmetries can be reduced. This is especially important because only a few small firms have access to fixed-interest loans or to bank credit (because of the high transaction costs). Small firms can, in this respect, have an advantage when compared to medium-sized firms.

3.3.3 Technology and Inputs

Small firms often have the ability to recycle and re-use materials. They use traditional or intermediate technology that can more easily accommodate the variations in inputs and equipment. Anyway, they are mostly labour-intensive, rather than capital-intensive. Thus, most small firms are not that dependent upon functioning input markets, imports, etc. (see 4.4). That means that they may be better prepared to address the issue of market failures than larger firms.

3.4 Government Policy, Bureaucracy, Regulations

Policy can artificially raise the profitability of small firms, by reducing the effectiveness of market forces. The less efficient firms are protected from the market discipline and allowed to survive. There are various laws and regulations that can more easily be by-passed by small firms. Among these are labour regulations, social security, taxes, fees, urban planning, civil laws, environment and hygiene regulations, etc. The weak administration usually faces great difficulties in enforcing these regulations, especially in rural areas. Not complying with the regulations provides a great cost-advantage. Other reasons to stay small, or, at least, to look small, are the high cost of legalisation and the excessive amount of red tape required (IFC 1996).

On the other hand, governments usually favour the larger firms. They benefit in various ways from protection, subsidised credits, privileged access to equipment, direct subsidies, tax incentives, etc. They are considered the real, or the only, engine of progress. This especially holds in former socialist transformation economies like Mozambique, in which the larger firms were owned by the state and considered a reason for national pride.

3.5 Managerial Abilities

There is evidence that the entrepreneurial skills and preferences can limit the firm size. Many countries in Africa simply did not have any local entrepreneurs while under colonial rule. For instance, it is only from the eighties onwards that one can talk of “Mozambican entrepreneurs” (Fialho Feliciano, 1996, p. 25).

Cultural factors – and, again, the socialist past – also influence the skills and the willingness to be an entrepreneur. Factors like individualistic vs. collectivist behaviour, the distance to power or the attitude towards risk either restrain or promote the business activities (risk-averse people remain as wage workers or, at least, keep their business small). Therefore, Mozambique does not seem to have the optimal preconditions for the emergence of a dynamic population of entrepreneurs (Correia; Reis 1996). Anyway, many small business entrepreneurs lack the skills to run formal organisations, especially large ones (Billetoft 1997). The absence of accounting skills limits them to informal activities.

3.6 Conclusions

By reviewing the various theories on the size of firms, we find that when there are significant returns to scale, large firms dominate, whereas when the cost advantages of the small size are large, small firms become an important, albeit volatile, part of the firm population. Small firms take advantage of market niches, lower labour costs and the ability to evade laws and regulations. Medium-sized firms are too small to capture returns to scale but they are nevertheless too large to take advantage of the aforementioned advantages of small firms.

All this leads to a dual industrial structure. On the one hand, we find a large number of highly volatile small firms and, on the other hand, there are a few large firms, which benefit from returns to scale, government protection and/or foreign capital. What is missing is a good industrial linkage and an industrial "middle-class", which is a crucial element for a competitive industrial structure and efficient networking to occur in each country (Biggs et al. 1999).

If we look back at the "reasons to be", we conclude that most small firms will not grow, because, if they did, they wouldn't be competitive anymore. They prefer to remain small and /or informal: otherwise, they would lose part of their advantages (no taxes, low salary, no social standards, informal finance, family business, flexibility, no bureaucracy, etc.) – a loss which the advantages of growth would not make up for.

This holds for as long as the barriers to growth are not removed, or at least reduced. The barriers to growth are:

- inefficient markets, implying high transaction costs
- lack of trust and honesty in the business culture (no culture of risk-sharing)
- inefficient, old-fashioned legal system (enforcement problems)
- red tape, high legal requirements, rigid bureaucratic regulations
- corruption
- lack of managerial skills/entrepreneurship
- lack of information on the advantages of formality.
- lack of transparency and information in the market for sub-contracting

4 Some empirical evidence from Mozambique

The PAPIR sample we have used in our study is based on internal registration documents of the PAPIR-clients[2]. The registration documents were not designed for research purposes. Nevertheless, the interviews and the updates allow us to apprehend some of the characteristics of Mozambican small firms, as well as some of the reasons for their existence. The updates also make it possible to demonstrate the high

2 The small firms interviewed were clients of the Danish PAPIR project in Sofala (PAPIR = Projecto de Apoio às Pequenas Industrias Rurais). PAPIR supported small firms, especially small-scale manufacturers, in the post-war period, with technical assistance and, later on, with credits. In 1998, this project came to an end after 10 years of activities. In the beginning of the PAPIR project, firm promotion served as a means to help refugees and aliviate poverty. Later on, it focused on business growth instead. Nevertheless, this was never clearly defined. (see also Cotter 1996).

volatility of small businesses and highlight some correlations, which could be interpreted as “success factors”.

4.1 How many have survived?

The small business sector in Mozambique is highly volatile. Out of a total of 1037 PAPIR small business clients (1987 - 1997), only 58,4% (606) had survived by 1998. Our latest update, in 1999, showed that only 427 (41,1%) had survived by then. Between 1998 and 1999 only, 29,5% of our sample have shut down.

Table 1: Sectors of activity and number of surviving small businesses (PAPIR)

Sector	**PAPIR clients 1987-1997**	**1998**	**1999**
Petty Manufacturers	497 47.9%	217 35.8%	155 36.3%
Petty Trade	242 23.3%	217 35.8%	159 37.2%
Service	298 28.7%	172 28.4%	113 26.5%
TOTAL	**1037**	**606**	**427**

4.2 Informal business

By 1998, 58,1 % of these small firms were informal businesses, in the sense that they were not registered and did not pay taxes on a regular basis (Navaia; Kaufmann 1999). The 1999 update indicated that, out of the surviving firms, 64,4% were informal businesses. This fact may indicate that survival in informality (without regular taxes, checks, etc.) could be easier. 62% of the small firms do not have a bank account, which correlates with the percentage of informality.

4.3 Growth

The 1999 update did not show any signs of significant growth. The average number of people employed went down from 2 to 1.6 employees per small firm. The average monthly income also went down to less than 40 US$ per month, for over 73% of the PAPIR small firms (1998: 52%).

On the other hand, the amount of capital invested did not show any increase in our sample. Over half of the small firms still operate on investments under 80 US$. 80 % have no access to energy and around 40% have no stable fixed location. Almost all of them work in a very labour-intensive and old-fashioned way.

The few small firms that have made larger investments show a strong positive correlation with the ones in which the number of employees has grown (see Table 2).

These firms do not replace labour for capital. Instead, they need capital as a complement, in order to prevent the fall in productivity and be able to grow.

Table 2: Number of workers employed and investment

N.º of workers	Equipment 1998		Equipment 1999	
	<=80 US $	> 80 US $	<= 80 US $	>80 US $
0	44 65.7%	23 34.3%	63 70.8%	26 29.2%
1	60 62.5%	36 37.5%	35 53.0%	31 47.0%
2	45 49.5%	46 50.5%	20 44.4%	25 55.6%
3	23 34.3%	44 65.7%	14 35.0%	26 65.0%
4	13 48.1%	14 51.9%	3 13.6%	19 86.4%
5-10	4 10.5%	34 89.5%	1 10.0%	9 90.0%
>=11		11 100.0%		7 100.0%
Total	**189** **47.6%**	**208** **52.4%**	**136** **48.7%**	**143** **51.3%**

Significance = 99.9%   Pearson's R = 0.342 (1998)
Significance = 99.9%   Pearson's R = 0.396 (1999)

4.4 Problems

The main problem with many small firms still is the lack of capital and access to credit. Two thirds complain about having missed opportunities because of the lack of funding. On the contrary, the access to tools and raw materials, which used to be a problem in the post war period, is no longer a serious issue. Anyway, competition has risen significantly, which can be interpreted as a sign of economic growth and more efficient (informal) markets. The lack of capital and the rising competition may explain why not all small firms grow – some actually downsize. The latter display passive strategies, consisting of cutting down costs, rather than expanding or approaching the market in a more aggressive manner.

Given the high rate of informality, it is not surprising that the problems associated with formality (e.g. taxation) were not often mentioned.

4.5 Success

The success in terms of income is positively correlated with having a bank account and a formal license and with the amount invested. However, this only holds for a minority of more permanent businesses.

4.5.1 Monthly income

Maintaining relations with the formal banking system seems to be a necessary condition for growth and income increase. By 1999, over 90% of the firms with a monthly income over 80 US$ were “formal businesses”, in the sense that they had bank accounts (see tables 3 and 4).

Table 3. Monthly income and bank account

Minimum Income	Bank Account 1998		Bank Account 1999	
	Yes	No	Yes	No
<= 40 US$	86 27.8%	223 72.2%	90 28.8%	222 71.2%
>40 US$<=80 US $	81 45.5%	97 54.5%	52 63.4%	30 36.6%
>80 US $	55 51.4%	52 48.6%	30 90.9%	3 9.1%
Total	**222** **37.4%**	**372** **62.6%**	**172** **40.3%**	**255** **59.7%**

Significance = 99.9% Pearson’s R = 0.2 (1998)
Significance = 99.9% Pearson’s R = 0.4 (1999)

Apparently, unlicensed firms are necessarily small. Growth and success render them more public and notorious. Hence, formalisation is an inevitable step in the process of growing and succeeding.

Table 4: Monthly income and license

Minimum Income	Licensed 1998		Licensed 1999	
	Yes	No	Yes	No
< 40 US $	94 30.4%	215 69.6%	82 26.3%	230 73.7%
>40 US $<=80 US $	95 53.4%	83 46.6%	40 48.8%	42 51.2%
>80 US $	59 55.1%	48 44.9%	30 90.9%	3 9.1%
Total	**248** **41.8%**	**346** **58.2%**	**152** **35.6%**	**275** **64.4%**

Significance = 99.9% Pearson’s R = -0.22 (1998)
Significance = 99.9% Pearson’s R = -0.37 (1999)

In the labour-intensive small business sector, the amount invested shows a significant correlation with an increase in monthly income.

Table 5: Monthly income and equipment

Minimum Income	Equipment 1998		Equipment 1999	
	<=80 US $	**>80 US $**	**<=80 US $**	**>80 US $**
<=40 US $	142 63.4%	82 36.6%	115 57.8%	84 42.2%
>40 US $<=80 US $	32 33.7%	63 66.3%	19 32.8%	39 67.2%
>80 US $	10 15.2%	56 84.8%	2 9.1%	20 90.9%
Total	**184** **47.8%**	**201** **52.2%**	**136** **48.7%**	**143** **51.3%**

Significance = 99.9% Pearson’s R = 0.384 (1998)
Significance = 99.9% Pearson’s R = 0.307 (1999)

According to other authors (Elkan 1995, p. 102), it is dubious whether there are positive returns from training. In our sample we could not find any significant correlation between income (success) and training.

Table 6: Monthly income and training courses

Minimum Income	Professional Training 1998		Professional Training 1999	
	Yes	**No**	**Yes**	**No**
<=40 US $	48 15,5%	261 84,5%	42 13,5%	270 86,5%
>40 US $<=80 US $	31 17,4%	147 82,6%	19 23,2%	63 76,8%
>80 US $	18 16,8%	89 83,2%	10 30,3%	23 69,7%
Total	**97** **16,3%**	**497** **83,7%**	**71** **16,6%**	**356** **83,4%**

Significance = 14.6% Pearson’s R = -0.018 (1998)
Significance = 15.1% Pearson’s R = -0.147 (1999)

4.5.2 Labour Force

As we’ve mentioned before, growth in the informal sector is only possible up to a certain limit. The larger a firm gets, the greater the need to formalise the business. By 1999, all firms employing over 5 people were formal ones.

Table 7: Number of workers employed and license

Nº of workers	Licensed 1998		Licensed 1999	
	Yes	No	Yes	No
0	24 23.8%	77 76.2%	14 12.0%	103 88.0%
1	45 29.8%	106 70.2%	25 23.1%	83 76.9%
2	67 43.8%	86 56.2%	38 36.2%	67 63.8%
3	50 50.5%	49 49.5%	35 66.0%	18 34.0%
4	22 51.2%	21 48.8%	21 84.0%	4 16.0%
5-10	36 75.0%	12 25.0%	12 100.0%	
>=11	10 90.9%	1 9.1%	7 100.0%	
Total	**254 41.9%**	**352 58.1%**	**152 35.6%**	**275 64.4%**

Significance = 99.9% Pearson's R = -0.306
Significance = 99.9% Pearson's R = -0.513

The number of workers employed and the degree of participation in the formal banking system are positively correlated with income. This is due not only to the access to credit but also to the reputation improvement, which may be a success factor.

Table 8: Number of workers employed and bank account

N.º of workers	Bank Account 1998		Bank Account 1999	
	Yes	No	Yes	No
0	32 31.7%	69 68.3%	25 21.4%	92 78.6%
1	45 29.8%	106 70.2%	34 31.5%	74 68.5%
2	57 37.3%	96 62.7%	36 34.3%	69 65.7%
3	31 31.3%	68 68.7%	37 69.8%	16 30.2%
4	23 53.5%	20 46.5%	23 92.0%	2 8.0%
5-10	32 66.7%	16 33.3%	11 91.7%	1 8.3%
>=11	7 63.6%	4 36.4%	6 85.7%	1 14.3%
Total	**227 37.5%**	**379 62.5%**	**172 40.3%**	**255 59.7%**

Significance = 99.9% Pearson's R = 0.187 (1998)
Significance = 99.9% Pearson's R = 0.421 (1999)

Just like income, professional training doesn't seem to have any significant correlation with the number of employees. Thus, training seemingly isn't an important success factor, in terms of either growth or income.

Table 9: Number of workers employed and professional training

N.º of workers	Professional Training 1999	
	Sim	**Não**
0	22 18.8%	95 81.2%
1	14 13.0%	94 87.0%
2	18 17.1%	87 82.9%
3	6 11.3%	47 88.7%
4	5 20.0%	20 80.0%
5-10	2 16.7%	10 83.3%
>=11	4 57.1%	3 42.9%
Total	**71** **16.6%**	**356** **83.4%**

Significance = 43% Pearson's R = -0.040 (1999)

5. Summary

Running a small business in Mozambique, even in the presence of assistance from NGO's like PAPIR, is a highly risky activity. Many firms from our sample have already closed down and the performance of many small firms has, in the last year, been quite poor. Most of these firms are very labour-intensive and don't have access to energy or a stable working place. The growing competition is a problem, although there are positive aspects to it from the consumers' point of view.

Although most small business-entrepreneurs earn a minimum monthly salary of at least US $ 35, survival is the main concern for most of them. The chances of firm survival seem to be correlated with cutting down costs and remaining informal. The firms that behave like this can be characterised as mainly temporary and non-specialised businesses.

On the other hand, there are a few successful and growing small firms (according to the 1999 update, 5% of the total). They can be characterised as permanent specialised firms that have been able to overcome the small business dilemma. For these firms, informality is no longer a condition for survival. They maintain stable relations with the formal banking system and most have obtained licenses and tried to complement their capital investments with an increase in the number of employees[3].

Reflecting upon development policy and the instruments for the development of small business, it is clear that these two groups of small firms require different approaches. The large group of temporary informal businesses needs policies aimed at

[3] They have already over 3 full-time employees.

reducing poverty and stabilising the business activities, whereas the few growing small businesses need strategies that "promote and pick the winners".

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