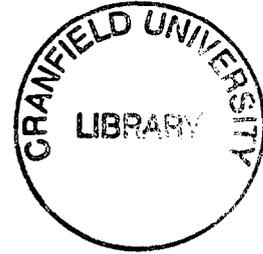




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**SWP 11/90 FINANCING SMALL ENTERPRISE  
IN DEVELOPING MINISTATES**

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## FINANCING SMALL ENTERPRISE IN DEVELOPING MINISTATES

### INTRODUCTION

The efforts of developing countries, both large and small, to promote the small business sector has been rightly recognized as crucial in their attempts to encourage self-sustaining economic growth. This paper focuses on one aspect of this issue that has been overlooked for too long: the question of how to encourage and develop small enterprises in small economies, and in particular the problem of financing small businesses in small isolated island nations

Conferences such as this offer a rare opportunity for both policy makers and practitioners alike to assess the success of initiatives to promote small enterprise and learn from the experience in other developing countries. They provide a venue where certain issues that may have been overlooked by mainstream research can be highlighted and discussed; in this case the problem of developing the small business sector in small economies. As there is a dearth of relevant material and informed comment on such issues, an opportunity such as this is of particular value. This lack of access to relevant research is a matter of obvious concern when one considers the number of reports commissioned by international agencies and governments that remain unpublished and have a restricted readership.

One consequence of this state of affairs is that both researchers and practitioners have to rely on studies and analysis of little relevance to the environment of most developing countries. Most of the research published internationally that is relevant to this subject has focused on initiatives undertaken in the developed industrial nations of Europe and North America. Furthermore those studies of relevance to the experience in Third World countries are commonly based on research in the larger developing countries. These are countries which usually have a large population, a relatively wide economic base, and often benefit from the advantages of continentality, with the associated infrastructural and market benefits.

In contrast the particular issues raised by experience of developing small enterprise in the smaller developing countries has generally been overlooked. This oversight is of particular concern in that the majority of developing countries can be classified as being small. There are a number of criteria which can be applied to assess "smallness", the most relevant of which are either population, geographical size, or gross domestic product.

Whatever the criteria adopted, it is clear from any review of the international taxonomies that a significant proportion of independent states and territories listed are in fact small with a limited economic base, small populations and few resources. For example a recent estimates suggest that as many as seventy independent states and territories have populations of less than 500,000. The great majority of these ministates (over 80%) are classified as LDC's, and of these the greater proportion are in fact island ministates with all the constraints commonly found in such small isolated island nations.

### ISLAND MINISTATES

A number of island ministates can be found located in the Caribbean and the Western Atlantic (e.g the Bahamas, Barbados, Dominica, St Lucia), off Africa and in the Atlantic (e.g Cape Verde, Madeira, St Helena, Sao Tome and Principe), in the Indian

Ocean (e.g the Comoros, Maldives, Mauritius, Seychelles), and in the Pacific (e.g the Federated States of Micronesia, Kiribati, Tonga, Solomon Islands, Vanuatu). The greatest concentration of such island nations can be found in the Pacific, where recent political and economic developments have highlighted the necessity of promoting the local business community. This was well exemplified by the recent coups in Fiji which were provoked in part by a desire of the Fijian people to be more directly involved in the local economy.

Apart from having relatively small populations, limited physical resources and a low GDP, island ministates are characterised by their geographic isolation, and their vulnerability to natural hazards and global market fluctuations. Their economic prosperity is often dependent on a narrow production base, commonly made up of only one or two primary products or a highly susceptible industry like tourism. Small island nations with their narrow economic base experience low productivity and high costs. Their limited size, isolation and the associated higher unit cost of infrastructure and production means that they have limited attractions to potential investors.

Furthermore these island ministates rely on a restricted number of export markets and import suppliers. Most island economies have been unable to diversify and so remain heavily dependent on imported goods, overseas markets and foreign aid. For example, the small island nations of the Pacific have become aid dependent economies with some of the highest per capita aid receipts in the world today.

It is against this background of the need for island communities to be less dependent on aid and become self-sufficient that efforts to encourage the small business sector in island markets must be seen. By the very nature of their size island economies can benefit from the opportunities inherent in a viable successful small business sector.

## **SMALL BUSINESS IN ISLAND MINISTATES**

The small business sector has an important role to play in ensuring balanced development in these underdeveloped ministate economies. It can act as a catalyst for growth creating new economic opportunities and generating new employment. But possibly of greater importance is that these small ventures can survive in markets in which larger operations cannot remain profitable.

In such small predominantly agricultural economies the small business sector has a significant contribution to make by providing services to communities where large firms cannot survive. Locally owned small enterprises can often successfully utilize local resources and labour, often using them more creatively and efficiently than can a larger operation. They are therefore well adapted to supplying goods and services appropriate to local market demand and meeting local consumer needs.

Such small ventures avoid the economic inefficiencies and structural inflexibility common to most larger economic entities operating in these island economies. This flexibility and adaptability is necessary in the small, diffuse markets often spread over a dispersed group of islands.

But entrepreneurs operating in these small isolated markets face problems peculiar to small island ministates. The viability of all island businesses is threatened by the limited buying power of the small relatively poor customer base. The commitments and obligations inherent in such close knit communities can place heavy demands on the time and resources of local entrepreneurs. If such demands are rejected the

entrepreneur risks alienation from the family and ostracism in the community, both of which can jeopardize future business dealings.

As compared to developed metropolitan economies most islands lack infrastructural support and have few resources to draw on. They have limited access to credit, technology or trained staff. The irregularity and uncertainty of transport links means that expensive stock, spare parts, and fuel have to be carried to cover delivery delays. This expense, as well as the cost of transportation and transshipment, is reflected in the uncompetitive prices charged to the consumers and the limited variety of goods offered. Training opportunities are limited, skilled workers at a premium, and advisory or accounting services are often non-existent. Financing small business is particularly difficult in these island ministates, capital is hard to raise and banks which are prepared to lend to small enterprise are far and few between.

### **THE FINANCES OF SMALL BUSINESS**

The full potential of the small business sector in developing ministates has yet to be realized. One of the major constraints faced by entrepreneurs in these small nations is their lack of access to finance and the failure of the banking system to meet the needs of the small business community in these states. This lack of finance results in most small businesses being undercapitalized, which as this paper suggests is as much a consequence of the failure of the small business community to gain access to finance, as it is the failure of financial institutions to identify the needs of these small businesses and react accordingly.

This paper draws on some recent research completed by the author whilst working at the East-West Center in Hawaii. This research was commissioned by island leaders because they recognized that the small business sector was essential for balanced development in island economies. The research, which was based on interviews with over five hundred entrepreneurs in seven island nations, focused on the role of the small business sector in the development of the small island nations of the South Pacific. The primary purpose of the research was to assess the social and economic factors that contributed to the success or failure of small business in the Pacific. From this analysis appropriate strategies and policy initiatives were identified that could be introduced to effectively support and sustain small enterprises. A matter of key concern was how best to provide financial support and ensure entrepreneurs were able to gain access to sufficient finance.

The research suggests that an underlying cause of business failure in the Pacific was that most small businesses did not have access to sufficient finance and as a result were undercapitalised. The evidence was clear that the majority of small businesses operating in the islands of the Pacific were in fact dependent on informal sources of finance. Thus local entrepreneurs generally financed their businesses by either drawing on personal savings, or pensions rights, borrowing from family sources or the sale of shares to friends and relations.

This well-developed non-institutionalized credit system was heavily dependent on family ties and local good will, although on occasion was supplemented by a network of local money lenders. Moreover in some cases local entrepreneurs depended on a regular salary to finance their business ventures. They continued to hold full-time posts, commonly in the public service, and as a result ran their businesses on a part-time basis, or relied on their family to handle the daily running of the business. Other forms of supplementary finance include funds arising from compensation awarded due to some

personal tragedy or family dislocation. For example, in the Marshall Islands the compensation paid to islanders affected by testing U.S nuclear weapons in the 1950's has been used to finance many local businesses.

One consequence of this reliance on informal sources of finance was that most small businesses in the Pacific islands were badly undercapitalized. They have a small financial base and limited assets. This poor financial position not only jeopardizes plans for future expansion and long-term survival, but was also one of the major causes of business failure in these island ministates.

The effects of undercapitalization include recurrent liquidity problems, a limited range of stock or equipment, substandard business premises, poor location, little promotion or advertising, an inability to finance effective expansion and as a result endemic financial instability. Undercapitalization appears to be a recipe for business failure.

### **FINANCING SMALL BUSINESS: THE BANKER'S PERCEPTION**

The continued reliance on informal, non-institutionalized credit resources results from the difficulties that many small businesses have in raising funds through formal banking institutions. Research results from seven different island nations show that only a third of those entrepreneurs interviewed had access to funds provided by their local bank, and that the majority of small businesses received no financial support from the formal banking system. Yet this did not appear to be a result of the lack of ready finance, more a consequence of the failure to access such funds.

The banks that do operate in the Pacific islands generally have adequate financial resources; there is no shortage of business capital in the islands. The banking system is made up of well capitalized government sponsored development banks or branches of major international banking operations like the Australian Westpac Bank, the Bank of New Zealand, the French controlled Banque Indo-Suez, or the Hongkong Shanghai Bank.

Local bankers claim that they are willing to lend to any viable commercial proposition, but that local entrepreneurs are unable to put forward viable investment proposals. Moreover their experience has been that as a rule loan applications from small businesses are rarely supported by accurate market projections, viable business plans, or even the most basic information. All too often the lack of effective planning had resulted in overambitious undercapitalized proposals whose success was not only threatened by a lack of capital and poor cash flow but also by insufficient resources and inappropriate skills.

Bank officials also noted that beside having to carrying the cost of bad loans, that the administrative costs of processing large numbers of small loans were a drain on meagre bank resources. It was obviously more cost effective for the bank staff to handle a small number of larger loans. The impact of such considerations are obviously exacerbated in small island nations where banks have only a few branches and limited trained staff.

In general the record of small businesses in these island economies is poor, and they have a high failure rate. From the banker's perception island entrepreneurs seemed to have an inability to appreciate the extent of long term financial commitments and the cost of recurrent expenses or cash flow needs. And in many cases they could only survive by being granted a moratorium on loan repayments, or renegotiating with the

bank the terms and conditions of their loans. Local entrepreneurs therefore seemed unable to master basic bank procedures and meet the simplest banking requirements.

Thus to most bankers in the region it appears that most potential borrowers in the small business sector have little understanding of the financial realities of business, and are ignorant of basic bank practices. With this perception in mind it is understandable why small businesses are perceived as high risk clients who are likely to default on their loan repayments, and as result banks are understandably unwilling to lend to this sector.

### **FINANCING SMALL BUSINESS: THE ENTREPRENEUR'S PERCEPTION**

Various reasons were identified in the research to explain the inability of local entrepreneurs to raise funds from local banks. In general most of the entrepreneurs felt that both commercial banks and government sponsored development banks neglected the needs of small indigenous businesses, and even discriminated against them.

Commercial banks were the most severely criticised. For apart from lending expensive short-term working capital, they appeared to avoid lending to small businesses at all, relying instead on the government sponsored development banks to take the risk of promoting the local small business community. Many of the entrepreneurs interviewed claimed that local banks appeared to favour large well-established businesses with a proven track record, and as a result showed little concern for the special problems facing small businesses operating in this particular environment.

Some of the reasons for this apparent disregard of the small business sector by the banks have already been noted. They include the understandable perception held by many bankers and loan officers that small businesses operating in such small markets are prone to failure and as such are high risk borrowers. This situation is aggravated by the inability of most potential entrepreneurs to meet the bank's basic demands either in terms of providing necessary information or sufficient collateral.

Entrepreneurs complained that the banks were not sensitive to their particular needs, and as a result failed to support what should be a large and important section of the local economy. Banking officials were also criticised for overlooking the socio-economic environment that their potential clients were operating in, and in particular the demands placed by the communal nature of island society, the constraints imposed by a communal land tenure system, and the small scale and dispersed nature of island markets.

Amongst the many concerns voiced by local entrepreneurs was the perception that the size of the collateral or security demanded by the banks was excessive and inappropriate not only in terms of their own resources, but also in the context of the local economy. In the same vein they complained that banks made their application forms purposely difficult, using complex banking terminology that was all too often poorly explained and rarely translated into the vernacular.

Furthermore many small-scale entrepreneurs suggested that banks should take into account their limited exposure to the complexities of accounting and the technical aspects business practice. They complained that because of the lack of available training they were unable to prepare viable business plans or establish clear business objectives. Moreover it was apparent that few entrepreneurs had the experience or skills to interpret financial data and therefore predict potential problems, let alone evaluate the financial

ratios or cash flow forecasts demanded by the bank.

This limited skill base meant that in many cases potential borrowers were unable to generate the information required by the bank to secure a loan, let alone supply accurate financial data or assess the size of their potential markets. Bank sponsored feasibility studies were therefore of limited value because little accurate data was available and as such it was virtually impossible to make any realistic projections. It became clear that if entrepreneurs were to raise sufficient capital they needed to be provided with the necessary skills to not only effectively apply their business plans, but also have the wherewithal to marshal and control the necessary resources.

## CONCLUSION

One consequence of the lending policy adopted by banks in these island ministates was the increasing levels of public criticism being focused on the banking sector. Local entrepreneurs who saw the commercial banks supporting large well established concerns or lending to part-foreign owned joint ventures felt quite justifiably they were being discriminated against. It was even suggested that this was a conscious attempt to starve these small businesses of capital in an effort to ensure they were less able to survive, and so not become competitors who could threaten established businesses.

As a result of this and similar concerns bank policies became the subject of debate and media comment. Politicians questioned the priorities of bank officials and the role of the banks in the local economy. Bank policy, and in particular the attitude of banks to the small business sector, became part of the political arena. The political dimension of financing small business deserves more research, particularly as increasing levels of political interference in the banking sector can have considerable influence on the degree of access to loan finance.

The evidence suggests that the small business sector has been grossly neglected by the formal financial sector in these island ministates. This enforced reliance on personal savings or the generosity of family or friends has jeopardized the growth of the local business community and is therefore seen as being detrimental to the balanced development of these small developing countries. Moreover because of its strategic importance in these small economies the issue of finance for small enterprise threatens to become a political football. A development that in the long run will confuse the issues involved, and could make it even harder for small business to access funds.

This brief review of the issue of financing small enterprise in developing ministates raises some fundamental questions about banking practice in developing countries. It is clear from the research in the island ministates of the Pacific that banks need to be more sensitized to the needs of the small business sector, and that those running small enterprises themselves need more understanding of bank practices and the mechanics of handling their financial resources.

Thus in conclusion it is proposed that banks need to invest resources, both financial and intellectual, in developing practices and procedures that are appropriate to the environment in which they operate. But of greater importance for potential entrepreneurs is that training programmes and advisory services focus on the idiosyncracies of local banks and highlight the value of developing business plans that

meet their requirements. Only then will those starting small businesses gain access to sufficient finance to ensure long term survival.

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