



Research Report 18

**IDENTIFYING KEY SUCCESS FACTORS
AND CONSTRAINTS IN ETHIOPIA'S MSE
DEVELOPMENT:
AN EXPLORATORY RESEARCH**

By

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Executive Summary

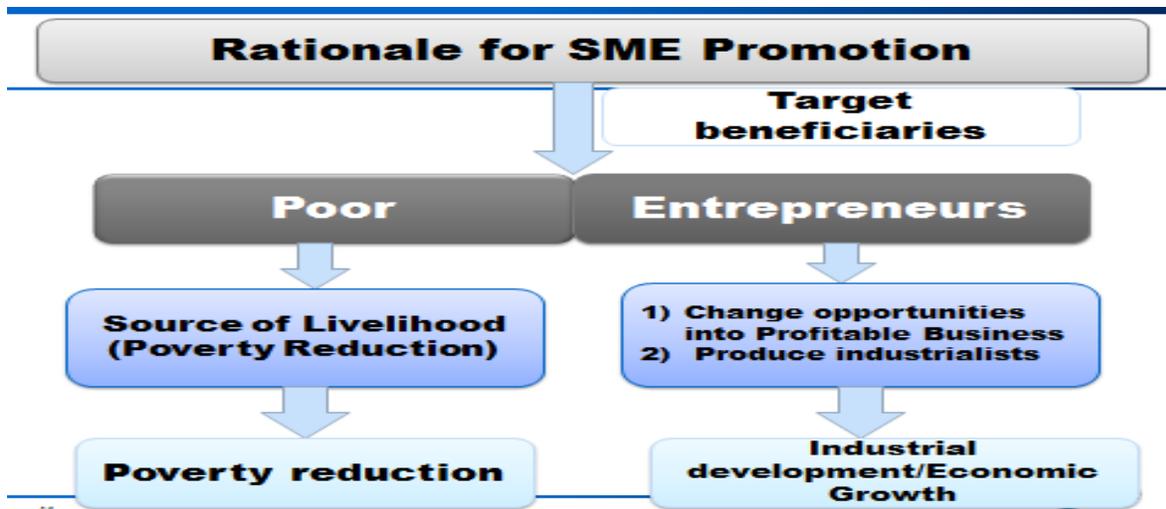
It is well established that MSE development can create huge employment opportunities and hence reduce poverty. Ethiopia has launched various bold initiatives and development policies and plans to spur economic growth. Three major development plans have been executed so far, the last one being the ongoing Growth and Transformation Plan (GTP). The common and overarching objective of these development plans has been to ensure broad based economic growth. This is so because broad based economic growth is the main route to poverty reduction through employment generation. Ethiopia has prioritized on MSE development for economic growth, employment generation and building an industrial economy. To this end, in 1997 the government has designed a National MSEs development and promotion strategy which facilitates and paves the ground for the growth and development of the sector. The strategy was revised in 2010/11 with renewed interests and more ambitious targets on employment and number of entrepreneurs and transition to medium size level. The primary objective of the strategy framework was to create a favorable environment for MSE development and to provide a more targeted policy support to MSEs so that MSEs could facilitate economic growth, create long-term jobs, strengthen cooperation between MSEs, provide the basis for medium and large scale enterprises and promote export. In this strategy framework, the government prioritized those enterprises having features like manufacturing and processing.

Despite its importance, the size of the Ethiopian MSE sector is less known. The MSE sector is a key target sector but its current size or performance in terms of its contribution to GDP, Employment and Export and total manufacturing output is largely unknown. Moreover, given the importance attached to the MSE sector and massive support extended, results are less known. During our consultation with key MSE policy implementers (including FeMSEDA), these problems were acknowledged and the authorities stated to us that these are among the priority works. Based on our preliminary findings, the key success factors tend to be personal qualities such as having an articulate vision or ambition and innate abilities, working experience in the formal sector as a factory employee or having worked in family businesses, managerial and entrepreneurial skills and higher equity in the invested money. Except for personal traits and qualities, many of the success factors stated above can be emulated through teaching and training. On the other hand, key constraints include: shortage and small size of credit, shortage of working and sales spaces, lack of rental machinery and stringent licensing requirements.

1. Introduction

Ethiopia has prioritized on MSE development for economic growth, employment generation and building an industrial economy. To this end, in 1997 the government has designed a National MSEs development and promotion strategy which facilitates and paves the ground for the growth and development of the sector. The primary objective of the strategy framework was to create a favorable environment for MSEs so that MSEs could facilitate economic growth, create long-term jobs, strengthen cooperation between MSEs, provide the basis for medium and large scale enterprises and promote export. In this strategy framework, the government prioritized those enterprises with features like manufacturing and processing various commodities, self-employment particularly by disabled and unemployed youth, start-ups and expanding firms owned by women etc. Following the 1997 MSEs Development Strategy, the Federal Micro and Small Enterprises Development Agency (FeMSEDA) was established by the council of ministers regulation number 33/1998 to lead and stir Ethiopia's MSE development. The agency has been established as an autonomous government institution under the supervision of the Ministry of Urban Development and Construction. The primary goal of the agency is to implement meticulously the strategies mentioned above. To implement the MSE policies and strategies, Regional Micro and Small Enterprise Development Agencies (ReMSEDA) have been established.

Drafted in 2002, the Industrial Development Strategy (IDS) of Ethiopia hinges on principles that ultimately would deliver agriculture-led industrialization, export promotion and development and expansion of labour intensive industries, a large part of which is the MSE development. The strategy assigns an indispensable role to the private sector. The drivers of this whole process would be enterprises engaged in the manufacturing sector. Specifically, the MSE sector is envisaged as a priority sector for multifaceted government support. This is also clearly indicated in the GTP. The overall aim is not only to reduce poverty in urban areas through employment generation but also MSEs serve as a playground for the emergence of entrepreneurs and lay foundation for industrial development (see figure below).



Spearheading the multifaceted government support on MSE development are the Federal and Regional MSE Development Agencies (FeMSEDA and ReMSEDA), which also have lower administrative units to enlarge their outreach.

The MSE support has three critical elements: first the strategy espouses to create and implement an enabling legal framework. Second, it envisages establishing user friendly business environment, for example, by simplifying and standardizing of documents, processes and services. Finally, the government offers direct policy support by devising targeted and specific support programs such as access to finance, access to appropriate training and technology, marketing linkage, provision of physical infrastructures and access to working and selling spaces and other handholding supports as deemed appropriate. The GTP tries to link the multifaceted government support with concrete targets on employment, number of trainings, market linkages to be created and so on. For instance, since employment creation is the primary target, the GTP plans that MSE would be supported to create an employment of around three million jobs by the end of the GTP period. It further aims to provide trainings for approximately ten thousand professionals in the sub sector. Similar targets are indicated in terms of the other supports as well.

Despite its importance less is known about the MSE sector in general and the MSE promotion strategy in particular. In order to come up with a more analytic research work, one has to have basic knowledge of the sector. This research work aims to conduct an exploratory research by describing the existing support mechanisms, the performance of the sector and the key success factors and constraints facing the sector. Such basic knowledge of the MSE sector would help us come up with a more analytic research work explaining why some MSE firms succeed and others fail, which we plan to conduct in the second phase of this study.

2. Objectives and Methodology

This research work is an exploratory research with the purpose of exploring the MSE sector for better understanding and testing the feasibility of a more extensive study, or determining the best methods to be used in a subsequent more analytic study. For these reasons, this exploratory research is broad in focus and rarely provides definite answers to specific research issues. The objective of this exploratory research is to provide overall picture of the MSE sector by describing the existing policy support and identifying key factors affecting the success and/or failure of Micro and Small-scale Enterprises in Addis Ababa and five other major regional towns in Ethiopia. After identifying success factors, the study tries to elucidate how such success factors and behaviors were developed and whether they can be emulated. The study also tries to identify key issues and bottlenecks in MSE development.

The study is mainly based on extensive literature review including MSE policies and strategies of the country and conducting focus group interviews with service provider government agencies and MSE operators themselves. The target stakeholders considered in this diagnostic study at the regional level comprises MSE development bureaus, micro finance institutions, TVET Agencies, Trade and Industry Bureaus and individual MSEs. A research team from EDRI visited Addis Ababa and five other major regional cities - Mekelle, Bahir Dar, Adama, Hawasa and Dire Dawa for this purpose. In addition to describing and characterizing the MSE sector, the study will help in laying the basic foundation for a more analytic work in subsequent studies.

3. Main Findings

3.1. Ethiopia's Definition of MSE

a) The 1998 definition of MSE

The old (1998) definition was based on paid capital only (see table below). An enterprise is categorized as micro if its paid up capital is less than or equal to 20,000 ETB. Similarly, an enterprise is considered small when its paid up capital is less than or equal to 500,000 ETB.

Sector	Manpower	Paid up capital
Micro enterprise	-----	≤ 20,000 ETB (1200 USD)
Small enterprise	-----	≤ 500,000 ETB (30000 USD)

Source: FeMSEDA

The limitation of this definition is that it does not provide information on job creation, size and asset base. This is because employment and asset ownership are not part of the definition. Secondly, the definition does not differentiate between manufacturing (industry) and services.

b) The New (2010/2011) Definition

The new definition considers human capital and asset as the main measures (see table below). The new definition addresses the limitations of the old definition. Minimum asset requirement for services and industry is different as shown in table 2 below.

Table 2: New (Current) Definition of MSEs in Ethiopia			
Level of the enterprise	Sector	Human power	Total asset
Micro enterprise	Industry	≤ 5	≤ 100000(\$6000 or E4500)
	Service	≤ 5	≤ 50,000(\$3000 or E2200)
Small enterprise	Industry	6-30	≤ birr 1.5 million (\$9000 or E70000)
	Service	6-30	≤ birr 500,000(\$30000 or E 23000)

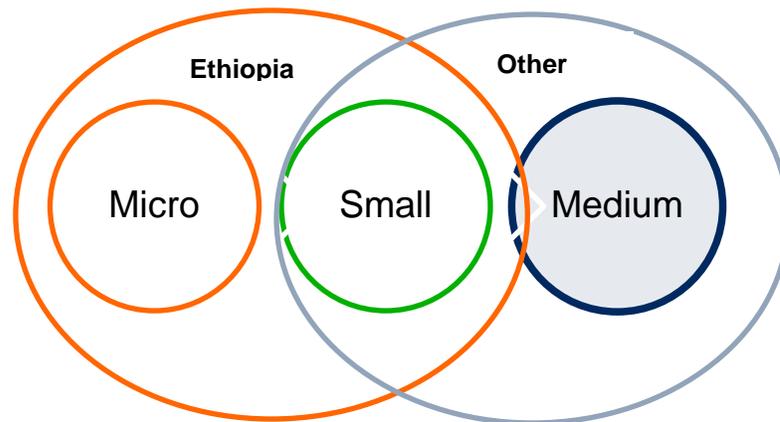
Source: FeMSEDA

The CSA conducts survey on small scale industries. It has conducted surveys for the years 2001/2, 2005/6 and 2007/8. However, CSA adopts its own definition which is not well aligned with the MSE policy and the new definition. Hence, the data it collects is less useful in terms of analyzing the MSE policy. CSA's definition is based on the size of employment and extent of automation. Hence, according to CSA,

- Large and medium scale manufacturing enterprises have been classified as establishments with more than ten employees using automated machinery.
- Small and medium enterprises are establishments that engage less than 10 persons using power driven machinery.
- Cottage/handicrafts are household type enterprises located in households or workshops normally using own or family labour and mostly manual rather than automated/mechanical machinery

The limitations of the CSA definition are, it ignores the size of capital and the sectors outside manufacturing.

Another point worth mentioning is that, while Ethiopia targets Micro and Small enterprises, many other developing countries target Small and Medium enterprises.



3.2. The Size of Ethiopia's MSE sector

The size of MSE is measured by its contribution to the GDP, Employment and Export and total and new annual establishments. How large is the Ethiopian MSE sector? The MSE sector is a key target sector but its current size or performance in terms of its contribution to GDP, Employment and Export and total manufacturing output is largely unknown. There is little or no information on the number of enterprises, the total sales, total employment and the number of newly-established MSEs. During our consultation with the FeMSEDA, they acknowledged this problem and explained that it is among their priority.

3.3. Ethiopia's MSE Promotion Policy

Ethiopia has launched various bold initiatives and development policies and plans to spur economic growth. Three major development plans have been executed so far, the last one being the ongoing Growth and Transformation Plan (GTP). The common and overarching objective of these development plans has been to ensure broad based economic growth. This is so because broad based economic growth is the main route to poverty reduction through employment generation. The role of Micro and Small

Enterprises (MSEs) is indispensable in poverty reduction through employment generation. Cognizant of this, a national MSEs Development Strategy was formulated in 1997. Ethiopia's MSE Policy envisages not only reducing poverty in urban areas but also nurturing entrepreneurship and laying the foundation for industrial development. The strategy was revised in 2010/11 with renewed interests and more ambitious targets on employment and number of entrepreneurs and transition to medium size level.

MSE development, being one of the key focus areas of the country's development strategy, receives massive support from the government in the form of access to finance, market, technology, training and working space. The government strongly believes that MSEs are the right solution to reduce urban unemployment and hence reduce poverty. This ambition is reflected in the GTP. For instance, it plans to create three million new jobs in the MSE sector in the five years growth and transformation period. Therefore, MSE promotion and support is the vital strategy to fulfill this national plan of employment creation in the short-run and achieving industrialization in the long-run. Ethiopia adopts a layered policy support in which MSEs are categorized into start-ups, growing-middle and maturity. Start-up stage enterprises refers to those enterprises found at their establishment stage and comprises a group or individual aspiring entrepreneurs that seek various supports to make their enterprise operational. The basic challenges at this stage include lack of initial and working capital, poor knowledge of business management and entrepreneurship and lack of knowhow about the different government policies and directives related to the sector. In order to mitigate these challenges, FEMSEDA has designed a strategy that focuses on facilitating access to initial capital, supporting MSEs in formalization and legalization process and provision of training on business management, entrepreneurship and production technique.

Growing stage enterprises refers to those enterprises that are competent in the market in terms of price and quality and successfully utilize the various government support packages and are profitable in their business. However, enterprises at this stage also suffer from different challenges like financial constraint, lack of appropriate technology

and technical skill, absence of sufficient working and sales premises and rent seeking behavior. To alleviate these specific challenges, FEMSEDA has formed a national strategy that focuses on facilitation of financial support and skill and technological development program. On the other hand, enterprises are considered to have reached the maturity stage when they are fully profitable and engaged in further expansion and investments in the sector. At this stage FEMSEDA has a strategy that aims to strengthen enterprises in terms of productivity and product quality. Moreover, at this stage, knowledge of international standards and better production technology are disseminated to enterprises. We discuss each of the direct government support to MSEs in subsequent sections.

3.4. Ethiopia's Direct Policy Support to MSE Development

In addition to creating a conducive business environment for MSE growth, Ethiopia extends direct policy support to MSE operators. The direct policy support includes access to markets, access to finance, access to industrial extension, access to training and technological support.

1. Access to Market

One of the major challenges that hampers the growth and development of MSEs in Ethiopia is access to sufficient and sustainable market. From our consultation meetings with various stakeholders, we identified the following support packages that the government is implementing towards mitigating this challenge. The government tries to solve marketing problems in at least three ways: firstly, the government itself buys goods directly from MSEs. Federal Public Procurement Administration Agency has set a rule that enforces public institutions to source certain portion of their annual procurement from MSEs. That is, MSEs are given priority in government procurements. Secondly, the government tries to link MSEs with large and medium enterprises in the market in the form of subcontracting and input suppliers. The FEMSEDA has introduced a new directive on franchising, sub-contracting and out-growth linkage with large and

medium enterprises. For instance, in condominium housing construction projects, 40% of the construction works mainly involving finishing such as sanitary, electric installation and other finishing works are given to MSEs. In addition, MSEs are involved in the national road construction projects particularly in the construction of feeder roads. Moreover, MSEs are taking part in power generation program that is undertaken by the Ethiopian Power Corporation; and there are similar efforts to involve MSEs in the country's mining sector.

Apart from market linkage with government projects, large private enterprises such as Mesfin Industrial Engineering, Metal Engineering Corporation, Sugar Corporation, MAA Garment were noted as private market linkages that have significantly involved the subcontracting of some of their works to MSEs. However, most of the market linkages created so far are government induced. Most of the government induced linkages create temporary employment opportunities. There is no strong market-driven linkage between MSEs and Medium and Large Enterprises. Thirdly, a number of bazaars and trade exhibition have been organized by MSEs development agencies to promote MSEs' products and to link them with large and medium enterprises and foreign buyers.

The main challenge with regards to market linkage is that MSEs depend to a great extent on the government to market their products. The government is the largest buyer and market linkage creator for their products. This has Made MSE operators to develop dependency and hence this kind of market linkage cannot be sustainable. MSEs need to gradually shift to market-driven market linkages on their own

2. Access to Industry Extension

The other area of MSEs promotion and support is provision of industry extension service. This strategy is adapted from Ethiopia's experience in agricultural extension. The primary objectives of the national industry extension service are to make MSEs competent enough in the market, to enable them to generate sufficient and sustainable

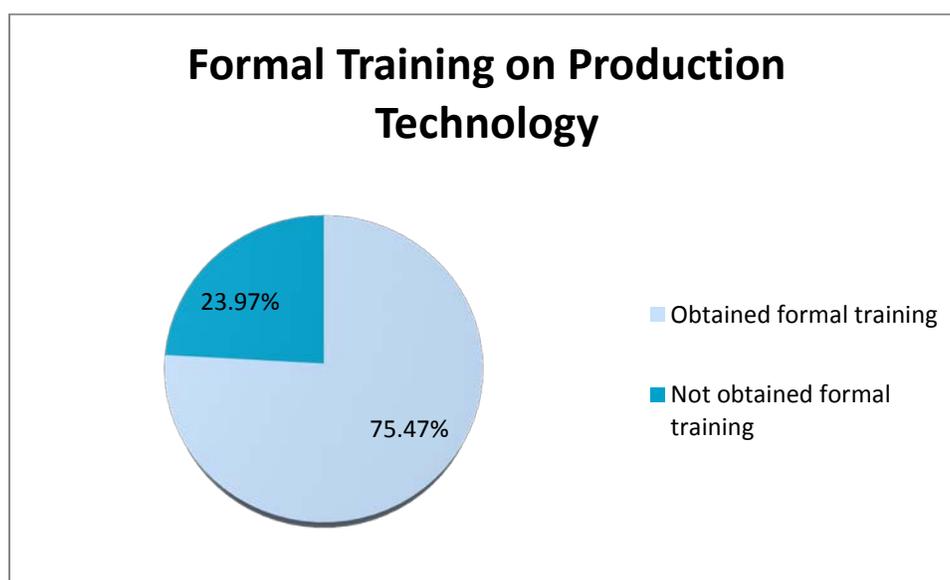
job opportunities thereby improving their income. The industry extension service elements consist of entrepreneurship, business development services, production technique, marketing management, supplies management, book keeping and continuous productivity improvement or kaizen. The mechanism of dissemination of the service is mainly through in-company training and consultation and through group discussions of enterprises that are engaged in the same sector. The beneficiaries of the industry extension service are selected based on interest, evaluation of individual demand and physical observation and evaluation of the enterprises' working premises. It is important that MSE entrepreneurs have the relevant academic background and appropriate work experience for them to benefit from the industry extension service. Moreover, the trainees should be fully prepared to practically implement the skills that would possibly be gained from the extension service.

Industry extension is implemented by TVET agencies in Ethiopia. Except in Tigray, in all other regions TVET instructors are responsible for the implementation of the national industry extension program beside their official classroom teaching duty. However, in Tigray, the regional government formed industry extension agents under the supervision of the regional MSE development bureau. These industry extension agents work fulltime with entrepreneurs or manufacturers giving them on-site all rounded support. One industry agent supervises around 70 MSEs on average. In the rest of the regions, TVET teachers do both classroom teaching (theory) to regular students and on-site industry extension service to entrepreneurs. The effectiveness of the two approaches needs further investigation. Industry extension service is provided for free. But when enough demand is created, MSE will be required to share some of the costs.

3. Access to training and technological support

Skilled manpower and the use of appropriate technology are critical inputs to nurture micro and small enterprises. In this regard, the national MSE promotion and development strategy paid due attention to human resource and technological development. Pertinent to human resource development, the government intervenes in the sector through two mechanisms. On the one hand, the government directly provides various skill trainings to potential entrepreneurs of the sector. For instance, as shown in

the figure below, a national survey conducted by the ministry of urban development and construction on 3029 micro and small enterprises revealed that around 76% of the enterprises had obtained a formal training on production technology and business management. On the other hand, the government also strengthens and supports MSEs through TVETs by producing skilled manpower that could satisfy the manpower demand of the different subsectors of MSEs of the country.



Regarding technological development, the government has been prioritizing those MSEs that are engaged in the manufacturing, construction and mining sub-sectors. The technological development strategy focuses on facilitating appropriate technology and production materials to MSEs in the form of purchase and lease. To this end, the government has proclaimed a new machinery lease policy in 2013. The Lease Company is planned to provide rental machines that are expensive for MSEs to own on their own. The government has also established a system that motivates individuals and other institutional actors to supply technology with fair price. It is also planned to provide on sight maintenance to machinery and equipment that are owned by MSEs through TVETs. The government also supports in the process of converting prototypes into commercially viable products.

4. Access to Finance

The other essential area of government intervention to promote MSEs is provision of financial support. In this regard, FEMSEDA has designed a national micro credit and saving directive that primarily focuses on alleviating the financial constraint of MSEs operating in the country. The priority areas of the national micro credit system include those MSEs that are engaged in import substitution, construction and export. This national micro credit and saving facility designed for MSEs has three different requirements. These are the credit requirement for start-up, growing and matured micro and small enterprises. First, MSEs at the start-up stage are required to save 20% of the loan within six months. For those who cannot afford saving 20% from their own sources or from their parents, the government provides them with job opportunities to raise seed money. Coble stone work is a good example. Second, similar to start-up enterprises, growing MSEs that are engaged in priority sectors are expected to save 20% of the credit within six months. However, growing enterprises that are involved in export activities are obliged to save only 15% of their credit demand. On the other hand those growing MSEs that are neither engaged in export nor in priority sub-sectors are forced to save 25% of their credit need within six months.

The third category of the credit requirement is for MSEs which are at maturity stage. Under this category, those matured MSEs that are engaged in export are obliged to save 15% of the required credit in six months period. Whereas those matured MSEs that are involved in priority areas are required to deposit 20% of the loan. Nevertheless, those MSEs at maturity stage and neither engaged in export activity nor in priority sub sectors are required to save 30% of their credit demand in six months period. The incentive to work hard and use the loan appropriately increases when MSEs pool at least 20% as equity in the form of minimum saving requirement. Higher equity also lowers delinquency rate.

5. Access to Working Space

Another critical factor for MSE growth is working space. In response, although the government has massively built working spaces for MSEs in major cities and towns, working space still remains a critical challenge. Rent is extremely high in major cities especially Addis Ababa. The supply of working spaces is small relative to demand. The problem is not only shortage, working spaces are built arbitrarily – for example, they are far from industrial zones. Market linkage may become easier if MSE are located near medium and large enterprises or industrial zones in general. MSEs can benefit from proximity to industrial zones.

3.5. Policy (Institutional) Coordination

The implementation of the MSE policy involves many government agencies – FeMSEDA and ReMSEDA, MFIs, Land Development and Management Bureaus, and other infrastructure providers such as EEPC, Ethio-Telecom and Water and Sewerage Management Authority. As a result of this, multi-agency support system policy coordination becomes a critical challenge during the policy implementation. In order to solve policy coordination problems, Ethiopia instituted coordination councils both at Federal and Regional Levels. At the Federal level, there is an MSE council that oversees policy implementation and coordination. The MSE council consists of Ministry of Urban Development, Housing and Construction (MoUDHC), Federal Micro and Small Enterprises Development Agency (FeMSEDA), Regional Micro and Small Enterprises Development Agencies (ReMSEDA) who are represented by regional Vice Presidents, Technical and Vocational Education and Training (TVETs), Ministry of Industry (MOI), National Bank of Ethiopia (NBE) and Ethiopian Revenue and Customs Authority. The Federal MSE council is chaired by the MoUDHC. There is similar council at the regional level, which is chaired by the Mayor in Addis Ababa and Presidents in other regions.

The council has steering committees which hold regular and extra ordinary sessions to deliberate on the challenges MSEs face and give strategic leadership to the sector.

FEMSEDA along with micro finance institutes and technical and vocational training institutes are the three implementing bodies that are responsible for implementing the national MSE strategy. The institutional decision making process decentralizes to the lowest administrative units, the kebeles. Within the kebeles, there is a one stop shopping service. The three implementing agencies have at least one staff at the one-stop service center to respond to MSE operators' needs in one stop. Officers from the micro finance institutions, industrial extension agents from the TVET bureaus and an expert from the micro and small enterprises development bureau combine their expertise to address the challenges MSEs face. The one stop service addresses all the needs of the MSEs. Technical, financial and administrative challenges facing MSEs are tackled with hands-on solution without any bureaucratic hurdles. It is supposed to save time and energy for MSEs.

When MSEs graduate to medium enterprises, the support packages they get will continue under the regional investment bureaus. Nevertheless, there is no package which looks after this transition. In a focus group discussion held with the graduated MSEs, they complained that the poor support availed after graduation has hindered the growth of MSEs. If MSEs are going to serve as bedrock for industrialization, continuous support packages should be institutionalized. This serves as an additional pull factor for many MSEs to apply for graduation.

3.6. Graduation and the Missing Middle

Policy support is not meant forever. MSEs should graduate after a certain time. MSEDAs have started graduating MSEs to medium enterprises since 2010. For example, a total of 619 MSEs have graduated in Addis Ababa, where 55.5% are MSEs engaged in the manufacturing sector particularly metal, wood and textile sub sectors. The city has designed sets of criteria used for the graduating process. In terms of total asset MSEs in the manufacturing sector should have a total asset worth 1.5 million ETB while service providing MSEs are required to have 500,000 worth of asset to qualify for

graduation. Some of the other graduation criteria include; a certain degree of technical efficiency, track record of loan repayment and saving with the MFIs etc. There is a steering committee which evaluates whether an MSE should graduate or not. In Addis Ababa, the committee is chaired by the head of the Addis Ababa trade and industry bureau. The committee meets on a regular basis to discuss problems facing the graduating MSEs. Initially, MSEs meeting the graduation criteria were reluctant to graduate for fear that they might lose the government support packages. Nevertheless, according to the bureau, because of the attractive support in place for MSEs after graduation, more MSEs are applying for graduation.

Graduating MSEs have been given prominence in recent years. According to experts at FeMSEDA, the agency has prepared nine indicators that qualify MSEs for graduation. The agency targets graduating 1% of MSEs every year. Once MSEs graduate to medium and large industries, the ministry of industry will take over the responsibility of supporting the graduates. Accordingly, the institutes like Leather Industry Development Institute, Metal Industry Development Institute and Textile Industry Development Institute and their regional affiliates are mandated to assist the graduates. Nevertheless, in a meeting with both the Metal and Leather Industry Development Institutes, there is no working relationship between the graduated MSEs and the institutes. According to an expert at the Metal Industry Development Institute, the only thing the institute did for graduates so far is to help them join the Basic Metal and Engineering Association thereby helping the graduates to get the support provided to members of the association. The graduates face the problem of the 'missing middle'; too big to meet their needs through the support packages availed for MSEs and neglected by other institutions. According to managers at Addis Saving and Credit Company, the missing middle are those graduating MSEs whose loan requests are too big to be met by the MFIs. Their demands are not met by commercial banks both because commercial banks follow stringent collateral requirements and target only big enterprises for loan. This has left the graduates in critical financial challenges. Moreover, there is no policy covering the graduates because they are in between. They are no more MSEs and

neither have they obtained an investor status. So, they are not only a missing middle in terms of accessing finance but they are a missing middle in terms of policy as well.

3.7. Key Success Factors for MSE Growth

We asked what the key success factors are for MSE growth to both MSE operators themselves and government policy implementing agencies. The key factors are summarized below

(a) Higher equity

Empirical studies show that equity promotes diligence and commitment; and lower shirking and delinquency rates. Those who have larger share in the total invested amount tend to perform better. Those who have started fully on government rendered money tend to perform less. The implication is that entrepreneurs should contribute enough equity to the total investable amount – large enough that makes them exert maximum effort.

(b) Prior working experience in formal sector or spin-offs

Those who have worked as employees in factories in the formal sector tend to perform better. They utilize their accumulated experience and knowledge to lead their own business.

(c) Family business background

Those who have worked in family business tend to succeed more than those who have not.

(d) Taking advantage of government training and support

Those who have utilized all available government support did well in business. Government not only provides resources but it also gives skill upgrading and entrepreneurial training.

(e) Smaller group

There are large number of business associations and cooperatives organized to do business by pooling their resources and skills. When business is done in groups, a group with small number of people tends to do well in business than a group consisting of large number of people.

(f) Manufacturing MSE

MSE manufacturing (especially metal and wood working) and construction tend to be more successful than other sectors in the Ethiopian context. This might be related to skill and experience. MSE in wood and metal works and construction are usually experienced and skillful.

(g) Skilled manager and entrepreneurial ability

If the owner is a skilled manager or hires one, the likelihood of success is high. The same is true for those who have vision and entrepreneurial ability.

3.8. Key Constraints to MSE Growth

(a) Access to Finance

Regarding access to finance, the problems are twofold. First, supply of credit is much smaller than demand. MFIs have only met about 50% of the demand for finance. Second, given that the prices of goods and services have been increasing, the real value of the loan is so small and does not provide MSEs much leverage. The Ministry of Urban Development, Housing and Construction (MoUDHC), which is responsible for overseeing the activities of MSEs in the country, conducted a national survey of over 3000 sample MSEs. In the survey, the MSEs were inquired to identify the major business constraints hampering their business. Access to finance tops the constraint list where 37.7% of the MSEs reported it as a key constraint.

The financial constraints facing MSEs is one of the critical bottlenecks for the growth of MSEs. Even though there are progresses made in the provision and service of loans, the sector is beset with a number of problems. Some of the more common problems facing MSEs include failing to get the loan they applied for and when they do, it is after a very long loan procedure. Repeated delays in loan delivery affect their business. The upper loan limit set by the MFIs falls short of the loan requisite of MSEs. Especially matured MSEs usually find it very hard to meet their loan requirements from MFIs. The MSEs feel that the interest rate and service charges are very high given the business environment MSEs face. However in a focus group discussion held with the management of Addis Saving and Credit Share Company, they said that interest rates are set in such a way that business and social roles of the company are met. They feel the interest charged is below the rate charged by other financial institutions. Lack of financial literacy on the part of MSEs and weak screening of MSEs, poor loan follow up mechanisms and inadequate branch networking and human capital related problems of MFIs have hampered the growth of the sector.

(b) Collateral Challenges

A proposed directive on loan provision for SMEs hinges on four main principles. The loan provided to MSEs shall primarily be sourced from savings. Savings/deposits constitute the major source, currently around 700 million birr followed by credit from commercial banks in special circumstances, and the city government of Addis Ababa makes financial injections. Second the micro finance institutes (MFIs) main credit targets are MSEs. MFIs serve as the financiers of MSEs. Third loan disbursements shall be based on the growth stages of the MSEs. Accordingly for startup enterprises working as individuals or cooperatives after securing 20% in compulsory savings, the balance is extended as loans for growth/matured enterprises engaged in the production of export products or in sectors deemed as priority, the compulsory saving is reduced to 15% of the loan. Finally all loans in principle should be paid back in full.

The directive outlines the sectors which get priority in the provision of loans. Value adding enterprises with the potential to graduate to medium and large scale industries

and firms engaged in the manufacturing sector which can serve as centers of new technologies are preferentially treated during loan application. It further entails that export producing enterprises and import substituting firms are served ahead of others. In order to encourage cluster formation, the directive prioritizes firms in an industrial cluster with good loan history which meet the criteria set by the lending micro finance institute.

According to article 626/2001 on the establishment of Micro Financial Institutes (MFIs), MFIs could lend to individual and cooperative borrowers. MFIs could disburse loans without collateral or using properties, dominant group guarantees or individual guarantees. Collaterals are crucial to ascertain that MSEs serve their debt on time. It also insures that MFIs will remain liquid and in business for a long time. Furthermore, since MFIs major source of loanable funds is their deposits raised from MSEs Collateral, indirectly debt serving is entwined with the very existence of the MFI. Finally, collaterals help ensure that the society in general and MSEs in particular develop the culture of timely settlements of debts.

In a focus group discussion with management of Addis Credit and Saving Company, they revealed that the company uses 13 alternative items as collateral based on the size of the loan and the type of business the MSE is involved in. Even though the size of the collateral should in principle be twice the loan, MFIs relax this stringent condition depending on client character and type of business. Some of the items used as collateral include living and business buildings, post-dated cheques, fixed business and household equipment, salary guarantees, sales outlets etc.

In order to expedite the loan provision and solve the problem of collateral to MSEs, regional governments create a Credit Guarantee Fund by taking into account the loan requirements of the MSEs found in the region at the beginning of each year. The fund will be renewed every year. The Credit Guarantee Fund so established will be held in a

closed account at the head quarter of the MFI. The MFI shall pay 5% interest on the amount deposited. Based on the loan requirement and growth stage of the MSE, the MSE development bureau shall write a letter to the MFI explaining that the MSE has been granted guarantee for the loan it applies for. The MFI shall cover 10% of the credit fund and beneficiary MSEs will be charged 1.5% of the loan to strengthen the financial capacity of the fund.

(c) Marketing Challenges

A marketing manual prepared by FEMSEDA identifies three market opportunities for MSEs. These markets are classified based on the geographic outreach of MSEs. In the beginning, the manual suggests that MSEs should target their immediate local markets where the rural-urban linkages could be strengthened through identifying and meeting the demand of the market. Once the local market is served, MSEs could broaden their scope and get more competent to serve the regional markets. Finally, MSEs could target supplying national and export markets. FEMSEDA has designed detailed marketing support schemes through which the government could facilitate the creation of sustainable market linkages. First, the federal agency and its regional affiliates will identify and avail detailed information about market opportunities to MSEs. To help the MSEs augment their competitiveness in terms of price, quality and supply, the agency will provide financial and industrial extension support packages. Second, the agency shall organize MSEs into cooperatives and create special marketing and sales strategies. These include wholesales and sales to consumers associations, exhibitions and bazaars, credit sales to government and private companies, taking part in governmental bids and creating subcontracting opportunities especially in the various governmental projects.

In this regard, during the construction of condominium houses MSEs are entitled to 30-50% of the total construction work. In a focus group discussion with the deputy head of the Addis Ababa micro and small enterprises development agency, we learnt that the city administration housing development has created significant market linkages with MSEs. Accordingly, 100% of the manufacturing of construction blocks. and pre-cast

beam and over 90% of the sanitary works is contracted out to MSEs . The housing project is the largest employer in the city. MSEs sub contract in the different mega government projects like construction of feeder roads from the Ethiopian Roads Authority, power generating schemes undertaken by the Ethiopian Power Corporation, and the construction of new universities. The agency encourages the use of abundant local inputs to produce local brands well known by consumers. In this endeavor, the agency studies the value chain of the input, identify the role of MSEs in the value chain, increase the value addition through industrial extension programme and finally ascertain that quality and standards criteria are fulfilled. The agency and its regional bureaus shall prepare sales outlets for MSEs Products. Towards this end, the bureaus identify products based on the value chain studies, construct market centers and display areas and popularize, promote and advertise through available media outlets. Moreover the agency supports import substituting MSEs. It studies products that are imported but could be produced locally by MSEs and classifies these products based on sector and prepares support packages in meeting the financial, skill and machinery gaps of MSEs. These are accomplished through the industrial extension support packages and campaigns to popularize and encourage the use of local products.

The agency has prepared a strategy to implement the marketing linkage programme. Firstly, database and data repository updated timely will be established at its different bureaus. Secondly, the technology support centers shall distribute new designs, patterns and standards to MSEs. Third, permanent display and sales centers dedicated to MSE products will be established. Finally, government procurement takes MSEs into account. The federal agency for the administration of government procurements have incorporated the percentage of government procurements which must be sourced from MSEs within the procurement contract. To further encourage participation of MSEs in governmental procurement, MSEs do not pay for bid documents and are not obliged to bring bid guarantees. They are exempted from advance and performance bond guarantees instead a letter by the regional bureau serves as a guarantee. Despite the efforts exerted to create market linkages there are a number of setbacks. Firstly, many

of the MSEs are not benefiting from the support schemes. And those who are beneficiaries expect governmental support all the time and lack personal initiatives to search for market by themselves. Due to failures to properly use the market linkage opportunities, MSEs have failed to serve their debts timely; their products could not be sold or are sold at loss. Rent seeking behaviors observed on both the MSEs and the bureau officials have exacerbated the market linkage problems. Most of the government induced linkages which target holidays and festivities create only temporary jobs. Furthermore the lack of detailed support packages and their poor implementation coupled with poor access to market information are hampering the development of MSEs.

(d) Working and Sales Space Constraints

Access to working and sales premises are also the other challenges to MSEs operating in the country. To this end, a national strategy was designed to construct appropriate working shades in different parts of the country. As a result considerable number of manufacturing and service rendering premises have been built and offered to both MSEs that are working in the manufacturing and service sectors. For enterprises at a start-up stage, the government has set a generous rent arrangement. Accordingly, in the first year of operation, MSEs are expected to pay 25% of the monthly price of the rent, in the second year 50 %, in the third year 75% and at the fourth year they will be obliged to pay the full price of the monthly rent.

In a focus group discussion with the Tigray Regional Micro and Small Enterprises Development Bureau, officials indicated that the regional government has built five big industrial workshops in an attempt to create linkages with Mesfin Industrial Engineering (MIE). The workshops were equipped with state of the art machineries which are used to undertake sub contract works from MIE. Currently, the MSEs are only responsible for handling the labor contract while MIE does the installation of the machines, the design, and quality control of the final produces of the MSEs. According to the regional MSED bureau, they have ordered the purchase of machineries from abroad to be installed in the workshops so that the MSEs could further be linked with other industrial firms in the

region. When the workshops are equipped with these machines, the MSEs are expected to independently design, produce and control their produces from beginning to end. The metal and engineering technology corporation of Ethiopia (METC) is building industrial workshops in a bid to strengthen its market linkages with MSEs. Accordingly, METC has built several workshops in many regional cities which are financed and equipped with financial outlays budgeted by METC. The MSEs are benefited in two ways; first, the MSEs are provided with industrial working spaces and second, METC sub contracts a portion of its industrial undertakings especially in the manufacturing of automotive parts for its assembly lines. Furthermore, the MSEs will be trained on the job to meet the quality and production standards of METC.

Even though the government pays due attention on the construction and expansion of working shades, the implementation has its own drawback. The working premises that are constructed to the manufacturing MSEs are located far from large and medium enterprises' industry zones. This has created problem to integrate or network MSEs with large and medium manufacturing enterprises. Moreover, the size and quality of the constructed working premises are not suitable for production and technological advancement. Another critical bottleneck identified by graduating MSEs is that the MSEs are expected to leave their working spaces once they graduate to medium enterprises. Even though the regional government's investment bureau is supposed to provide the graduating MSEs with land in the industry zones, there has not been the case in many of our focused discussions both with the MSE operators and the ReMSEDA. Most of the industrial zones we visited were still under construction or in distant neighborhoods with poor infrastructure and are detached from the large enterprises which affects the market linkages that might have been created with MSEs. Many MSEs meeting the graduation criteria do not graduate for the mere fact that once they graduated, they will be forced to leave their current working space leaving the MSEs with no option but to remain small all the time. Many MSEs use their workshops as sales outlets as well. However, some MSEs are involved in businesses that require them to go out to the market and sale their produces. Many MSEs sale to retailers and

wholesalers reducing their profit margins which they could have garnered if they were to sell their produces. In order to solve the problem of sales outlets the regional MSEDAs are constructing buildings designated for MSEs. In a focus group discussion with the Addis Ababa MSDA, we have learnt that the bureau is finalizing the construction of G+4 buildings in prime business locations in the city administration to be let out to MSEs.

(e) Capital goods and Machinery challenges

The capital leasing business proclamation recently amended as proclamation number 807/13 addresses the shortage of capital goods and the collateral requirements of MSEs. Accordingly, a capital good is defined as any equipment or machine that may be used to produce goods or provide services and includes accessories. However, due to the lack of detailed directives, the proclamation has not yet been implemented. There are two types of leasing arrangements; financial lease and hire and purchase lease. Both types of lease are similar in that the lessee will periodically pay a certain amount of money to the Leasing Company. The lessee will have the right to use the capital good/machine. In case of financial lease, the title deed shall be transferred only when the lessee completes payment. However, for hire and purchase lease it is possible to transfer ownership based on the percentage of the total lease amount paid by the lessee.

Before granting the capital lease loan, the lessee (MSE) had to save a certain compulsory deposit that varies depending on the stage of growth of the MSE. Start-up firms have to save for six consecutive months. Growing and matured enterprises need to save for a whole year while priority sectors and firms engaged in the production of exportable products have to deposit 20% and 15% of the loan respectively. Some MFIs have started providing capital financing for MSEs in the construction sector. In a focus group discussion with the management of Addis Credit and saving company, it was indicated that the company has disbursed some loans for the purchase of machineries using the machine as collateral jointly with the housing development project office.

In a focus group discussion with the deputy head of the Addis Ababa Micro and Small Enterprises Bureau, it is believed that when the directive for the operation of capital leasing is issued by the National Bank of Ethiopia, it will solve both the capital goods requirement and the stringent collateral requirements of Banks. Without any additional collateral, the capital leasing also known as 40/60 scheme makes MSEs owners of the machineries by raising 40% of the cost of the machine in deposits. According to the amended capital leasing proclamation, micro- financing institutions licensed by the National Bank of Ethiopia may engage in capital goods and finance businesses without the need to obtain any additional license. This amendment will benefit MSEs. In recent news article by The Reporter dated September 23, 2013, it has been revealed that Addis Saving and Credit Company is in the process of establishing a capital leasing company with an initial capital of 500 million birr. The company shall focus on firms engaged in the manufacturing sector according to the newspaper.

(f) Licensing and registration challenges

In Ethiopia, all MSEs are formal, properly licensed and subject to paying taxes as per the tax proclamation of the country. According to Addis Ababa Micro and Small eEnterprise Development Bureau, there are as much if not more informal firms as are formal firms in Addis Ababa. Some of the reasons attributed to the informality are high transaction costs during licensing, contraband, illegal under invoicing of imports. The bureau has no support scheme for informal firms but recently informal firms are organized and being provided with working space and stringent government control of informal firms have forced some to go formal. In a focus group discussion with experts at the Federal Micro and Small Enterprises Development Agency, the main cause of informality is tax avoidance or fear of exorbitant taxation. Hence, arranging tax incentives, reducing transactions costs and creating Sunday markets in which MSEs are registered are suggested as solutions to bring informal firms to formality.

According to article 686/2002 on the registration and licensing of enterprises, anyone person/ company has to come up with a permanent business address to get a license. In a letter addressed to Addis Ababa Micro and Small Enterprises Development Bureau,

the Ministry of Trade has relaxed this condition to MSEs. Accordingly, MSEs with no title deeds working at their places of residence or having no permanent address could get licensed on special conditions. The letter explains that in order to facilitate the roles MSEs play in creating employment and reducing poverty, the MSEs engaged in specific sectors could get licensed without permanent addresses. This is implemented in two ways. First when a letter of confirmation is provided from the Micro and Small Enterprises Development Bureau, MSEs could get licensed. Second, after confirming the existence of MSEs in a certain place and the fact that they are paying taxes and have settled payments for water and electricity services by the relevant woreda office; MSEs could get license and registration.

(g) Attitudinal Challenges

There are two conflicting schools of thought on the expansion of MSEs. The first school acknowledges the positive role MSEs play in the creation of opportunities for many especially the disadvantaged. MSEs are central in creating massive employment opportunities while reducing poverty in an economy. On top of these, MSEs form the basis for a number of developments in technology where new breakthroughs are made; MSEs serve as a spring board for the industrial aspiration of a country. Contrary to this the second school of thought considers the increase in the number of micro and small enterprises as a sign of failure of the economy to provide productive jobs; the sector is the last option which gives the bare minimum for subsistence support. People with no hope of finding formal employment are forced to engage in MSEs. It is considered as a place of last resort with little probability for improvement. Disfranchised people with less formal education are engaged in a one man or family run businesses with bleak hope for success. It is a sector characterized by poor productivity growth, informality and working on the margins where survival is the primary concern.

Even though there is a tendency for the former view to prevail over the later in recent years, there still remains a lot of hurdles in changing the attitudes of people on the role MSEs play. With the prioritization of MSEs given in the industrial drive of the country, designated bureaus are established with the sole role of facilitating the development of

MSEs. Furthermore, participation of a large number of the society in the sector and success stories albeit few emanating from the sector have played a significant role in boosting the image of the sector. However, MSEs are yet to overcome the negative images they had over many years. The perception that MSEs are yet to produce quality products that can compete with similar products is the primary challenge. Even though efforts are underway to popularize usage of local products with many exhibitions, bazaars and advertisements like the “ Buy Ethiopian”, there still remains a great deal of sensitization of the public that MSEs are as good as any similar product. Since old habits are hard to change this might take years.

Attitudinal problems of the private sector towards MSEs are reflected more importantly in the way that MSEs are crowding out the private investors. This is more visible in the construction sector. MSEs undertake 30-50% of the construction works in the state sponsored housing development project. Massive government infrastructure development projects have targeted creating opportunities for MSEs. This has created the sense that MSEs are favored by the government leaving the private investors as bystanders. The various governmental support packages that prioritize MSEs have left the private investors to be more antagonistic towards MSEs. This hampers the development of market linkages that would have been created between MSEs and private investors.

(h) Institutional Coordination Problem

Ethiopia’s MSE policy support is multi-agency. About 10 government agencies are involved in the implementation and follow-up of the MSE policy.. Consequently, , implementation coordination has been a challenge. The setting up of the MSE council consisting of relevant government agencies has eased the problem to a great extent but the coordination problem still exists. The Council has to be well-mandated and structured so that it addresses not only policy issues but also follow-up implementation issues on the ground; and for this, the council needs to have smaller units that can regularly monitor and follow-up implementation issues.

4. Conclusions

It is well established that MSE development can create huge employment opportunities and hence reduce poverty. Ethiopia has launched various bold initiatives and development policies and plans to spur economic growth. Three major development plans have been executed so far, the last one being the ongoing Growth and Transformation Plan (GTP). The common and overarching objective of these development plans has been to ensure broad based economic growth. This is so because broad based economic growth is the main route to poverty reduction through employment generation. Ethiopia has prioritized on MSE development for economic growth, employment generation and building an industrial economy. To this end, in 1997 the government has designed a National MSEs development and promotion strategy which facilitates and paves the ground for the growth and development of the sector. The strategy was revised in 2010/11 with renewed interests and more ambitious targets on employment and number of entrepreneurs and transition to medium size level. The primary objective of the strategy framework was to create a favorable environment for MSEs so that MSEs could facilitate economic growth, create long-term jobs, strengthen cooperation between MSEs, provide the basis for medium and large scale enterprises and promote export. In this strategy framework, the government prioritized those enterprises having features like manufacturing and processing.

Despite its importance, the size of the Ethiopian MSE sector is less known. The MSE sector is a key target sector but its current size or performance in terms of its contribution to GDP, Employment and Export and total manufacturing output is largely unknown. Moreover, given the importance attached to the MSE sector and massive support extended, results are less known. During our consultation with key MSE policy implementers (including FeMSEDA), these problems were acknowledged and the authorities stated to us that these are among the priority works.

The key success factors tend to be personal qualities such as articulate vision or ambition and innate abilities, working experience in the formal sector as a factory employee or having worked in family businesses, managerial and entrepreneurial skills and higher equity in the invested money. Except for personal traits and qualities, many of the stated success factors can be emulated through teaching and training. On the other hand, the key constraints include: shortage and small size of credit, shortage of working and sales spaces, lack of rental machinery and stringent licensing requirements. In terms of policy, there seems no policy that covers those that graduate from MSE support. Technically, graduates are in between MSEs and investors, and, hence, there exists no policy addressing the problems of graduates. Finally, another point of concern is institutional coordination. Since Ethiopia's MSE policy implementation involves a lot of government agencies including Micro and Small-scale Enterprises Development Agencies (MSEDAs), TVETs, MFIs, Ministry of Urban Development, Housing and Construction (MoUDHC) and other institutions, institutional coordination has been a challenge. To alleviate this, an MSE council consisting of relevant government agencies has been established but the council has limitations in what it can do in terms of its mandates and limited capacity to follow-up policy implementation. Finally, we would like to state that the observations and findings in this research report are preliminary aiming at understanding and exploring the MSE sector, which will serve as ground work to conduct a more analytic research work on Ethiopia's MSE development in subsequent studies.

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Annex

List of Bureaus Visited (for Focus Group Discussions)

1. FEMSEDA
2. Addis Ababa Micro and Small Enterprise Development Agency
3. Addis Credit and Saving Share Company
4. Addis Ababa Housing Development Agency
5. Metal Development Institute
6. Leather Development Institute
7. Tigray Region Micro and Small Enterprises Development Agency
8. Dede-bit Saving and Credit Share Company
9. Tigray Region Technical Vocational Education agency
10. Tigray Regional State, Trade and Industry Bureau
11. Oromia Micro and Small Enterprises development agency
12. Oromia Credit and Saving Share Company
13. Oromia Technical and Vocational Training Education Bureau
14. Oromia Trade and Industry Bureau
15. Amhara Technical and Vocational Training Education Bureau
16. Amhara credit and saving share company
17. SNNP micro and small enterprises development bureau
18. Omo Credit and saving share company
19. Dire Dawa City Administration Micro and small Enterprise Development Bureau
20. Dire Credit and saving Share Company