AN EXPLORATORY STUDY OF SMALL BUSINESS CONSTRAINTS IN ETHIOPIA: A CASE STUDY OF THE RETAIL CLOTHING INDUSTRY IN ADDIS ABABA

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ABSTRACT

Small business has long been touted as a driving force for economic development by way of the employment opportunities provided. In this context, the efficiency of small business should be of paramount concern to governments, particularly those with the responsibility of delivering economic growth and improved living conditions to the citizens of less developed countries. This paper presents the results of an exploratory study which sought to determine the primary constraints to efficiency and profitability for small businesses in Ethiopia. More specifically, the study focused on the retail clothing industry in Addis Ababa. The results of the study indicate that a number of constraints to performance were common. These include human resources, rampant corruption of government officials, high inflation, lack of finance, and dysfunctional competitive practices.

1.0 INTRODUCTION

The development of an efficient private sector in Sub-Saharan Africa is of critical importance in the quest to deliver sustainable economic growth and rising living standards in the region (Ramachandran & Shah 1999). In support of an efficient private sector, there are many factors that influence sustained economic growth, including geography, education, access to land and finance, and infrastructure (Bleaney & Nishiyama 2002). In addition, entrepreneurial activity and effective small business has often been proffered as an important mechanism to promote employment, productivity, and innovation, and hence, progress the economic development of a country (Daniels & Mead 1998; Klapper & Delgado 2007; Spencer & Gomez 2004; van Praag & Versloot 2007).

The World Bank, in its quest for the formula for economic development, suggested that the unit of measurement of entrepreneurship may be considered as "any economic unit of the formal sector incorporated as a legal entity and registered in a public registry, which is capable, in its own right, of incurring liabilities and of engaging in economic activities and transactions with other entities" (Klapper *et al*. 2007, p.4). While there is no suggestion of organisation size in the above definition, the proliferation of small business in Africa, and the dearth of large firms, would suggest that entrepreneurial activity and small business are two sides of the one coin. Indeed, small businesses are pervasive in the African commercial landscape. In Sub-Saharan Africa, 80 percent of firms are small (IFC 2006), and employ a considerable proportion of the available adult population. As such, most governments recognise the significance of the small business sector, and consequently place great emphasis on promoting this sector of the economy (Daniels & Mead 1998).

However, many constraints to small business remain in much of Sub-Saharan Africa. These constraints include unfair competition from the informal sector, poor access to land and infrastructure, lack of access to finance and requirements for collateral, low productivity of human resources, inequality in tax administration, and corruption (Amin 2007; Hansson 2004; Kellow 2007; UNCTAD 2006; UNCTAD 2007; World Bank 2003).

This paper will explore the constraints to the effective operation of small business in Ethiopia, with a specific focus on the retail clothing industry in Addis Ababa. The paper will begin by briefly reviewing the economic development of Sub-Saharan Africa since the 1960s, and the economic situation in Ethiopia. The paper will then outline the connection between small business and economic development, before proffering the methodology, results, and conclusions of the study.

2.0 ECONOMIC DEVELOPMENT IN SUB-SAHARAN AFRICA

On virtually every measure of economic development, the countries of Sub-Saharan Africa have demonstrated either stagnation or negative outcomes since the 1960s (Cheru 1989; Fosu, Mlambo & Oshikoya 2001; Thurow 2003; UNCTAD 2007). To exacerbate the situation, annual economic growth has generally been volatile, and well below the average 3 percent annual increase in population over the last 30 years (Arbache & Page 2007). Indeed, Sub-Saharan African countries must now maintain long-term economic growth of 6-7 percent to achieve any inroads into poverty reduction (Funke & Nsouli 2003; Hope 2002; Nyikuli 1999).

The parlous state of economic development in the countries of Sub-Saharan Africa has largely been attributed to internal factors, such as poor macro-economic and political fundamentals, including despotism, rampant corruption, and lack of infrastructure (Funke & Nsouli 2003; Mwakikagile 1999). At the core of Africa's repressed development since the 1960s is the failure of African leaders to provide effective government; "Africa has suffered grievously at the hands of its Big Men and its ruling elites" (Meredith 2005, p.686).

But external factors have also played their part to repress economic development. The pre-1960s colonial legacy left the countries of Sub-Saharan Africa with, firstly, commodity-based economies designed primarily to provide European markets with cheap raw materials (Davidson 1994); secondly, limited industrial sectors designed to supply the local market for some goods and secure a sink for European manufactures for most other goods (Nyikuli 1999; Seidman 1972); and thirdly, a low level of human resource development, which some believe was deliberately designed by the colonial powers to repress independence ambitions (see, for example, Meredith 2005).

Following the independence of most of the countries of Sub-Saharan Africa in the 1960s, successive governments nationalised industries and devised protectionist socialist policies to promote an import-substitution industrialisation strategy that never matured into exportled growth (Abegaz 1994; Okello 2003; Sachs 2005). The net result of this historical progression is not only repressed development, but also an inward orientation of business people that inhibits entrepreneurship, and ultimately, integration into the global commercial community (Clark 1995; Mwakikagile 1999).

Consequently, Africa today, remains on the periphery of global commercial integration. Africa contributes less than 1 percent of world trade, despite having 20 percent of the world's population (Ford 2002). More concerning is that Africa's contribution to world trade is down from 4.2 percent in 1960, and 3 percent in 1986 (Ibru 1997). Regional integration is also low, resultant from a "colonial tribalism" (Davidson 1994, p.198) style of rule that led to the fragmentation of the African continent; less than 5 percent of Africa's trade is with other African countries (Ibru 1997; Mwakikagile 1999; Quelch & Austin 1993).

Developed world perceptions now also contribute to Africa's continued low economic growth. From the perspective of the developed world, Africa tends to be associated with negative images, revolving around poverty, indebtedness, famine, ethnic conflict, HIV/AIDS, corrupt governance, and malignant instability (Ford 2002; Quelch & Austin 1993; Sachs 2005).

The above discussion would indicate that the economic situation in Africa overall remains tenuous for a number of reasons, including colonial legacy, poor macro-economic and political management, and developed-world perception. The next section will focus more specifically on the economic situation in Ethiopia.

3.0 THE ECONOMIC SITUATION IN ETHIOPIA

Ethiopia is a country located in the Sub-Saharan region of the African continent. The country's economy is highly dependent on agriculture; 48.8 percent of GDP and 77 percent of exports are agricultural (predominantly coffee, comprising 65 percent of total exports). Services comprise 38.3 percent of GDP, while manufacturing contributes 23 percent of exports (CIA Factbook – Ethiopia 2008; Economy – Statistics 2008). As a consequence of the dominance of the agricultural sector, 85 percent of the Ethiopian population of 77.4 million live in rural areas, and 80 percent are employed in farming activities (Facts and Figures 2008).

Economic growth has accelerated in recent years, albeit from an extremely low base. Economic growth during the 1970s and 1980s was <2 percent average per year, including periods of negative growth (Arbache & Page 2007); between 1992 and 1996 this increased to an average of 6.2 percent (Economy – Statistics 2008); by 2007 the GDP growth rate had risen to 9.8 percent (CIA Factbook – Ethiopia 2008). Despite this impressive rate of economic growth, which now rivals some of the highest rates of growth in Asia, GDP per capita remains appallingly low at US$560 (Economy – Statistics 2008). Indeed, 80 percent of the population subsist on <US$2 per day (Facts and Figures 2008), suggesting that discretionary spending is generally very limited and focused on the essentials of life. In addition, the impressive GDP growth rate of 9.8 percent must be viewed in the context of a population that is increasing at a rate of 2.6 percent per year, and an inflation rate of 16

percent (CIA Factbook – Ethiopia 2008). This might be compared to a high performing economy, such as that of China with a GDP growth rate of 11.4 percent, 0.6 percent per year population increase, and an inflation rate of 4.7 percent (CIA Factbook – China 2008).

Historically, Ethiopia was never colonised by European powers, except for the Italian occupation for 5 years from 1936 to 1941 (Zewde 2005). As such, an adverse colonial legacy does not exist, as it does, for example, in Rwanda (Mamdani 2007; Reader 1998). Since 1990, Ethiopia has maintained the overarching objective of economic transition from the command economy of the *Derg* to a market economy focused on the development of the private sector. While the objective still remains, the implementation has been stifled, reportedly because the government lacks the will to do so (Hansson 2004).

The poverty in Ethiopia, as well as its Government's inaction on economic reform, continues to foster a number of tangible constraints on entrepreneurial activities. Firstly, the major items of household expenditure for Ethiopian families are food (51 percent), housing/water/fuel (18 percent), and clothing/footwear (7.5 percent). The expenditure pattern is largely a consequence of household size, which in rural areas, averages 6 persons per household, and in Addis Ababa, 5 persons per household (Household Income, consumption, and expenditure survey – 2003/2004 2008). Discretionary spending is therefore extremely limited, and focused on the essentials of life. Secondly, education levels are low; 4.9 percent of people in rural areas, and 38 percent of those in urban areas, have completed upper primary schooling only (i.e., grades 7-8) (Household Income, consumption, and expenditure survey – 2003/2004 2008). This low level of education most certainly impacts adversely on the efficiency of small business (Daniels & Mead 1998; Djankov *et al*. 2008; Kristiansen *et al*. 2005; Ramachandran & Shah 1999). Thirdly, unemployment and underemployment is high; about 59 percent of the urban population is economically active; 48 percent of these are aged 15-29, reflecting a young population (median age: 18 years) with short life spans (life expectancy: 49 years). Of those participating in economic activity, 23 percent are absorbed in retail trade (CIA Factbook – Ethiopia 2008; Household Income, consumption, and expenditure survey – 2003/2004 2008).

In summary, Ethiopia is one of the poorest countries in the poorest region of the world. Recent economic growth has been impressive, but this needs to be viewed in the context of population growth, inflation, and the low economic base from which the growth is being measured. The country's economic volatility continues to be exacerbated by the frequency of climatic disasters (e.g., famine; floods), and conflict with neighboring countries (e.g., Eritrea; Somalia) (Hansson 2004). The proliferation of an efficient and effective small business sector is often touted as a mechanism for economic development because of the employment, productivity, and innovation opportunities offered. This issue is discussed next.

4.0 SMALL BUSINESS AND ECONOMIC DEVELOPMENT

Theories of economic development have evolved considerably from those of the early 20th-century theorists. For example, Fanfani (1935, p.217) suggested that the different rates of economic growth between Protestant northern Europe and Catholic southern Europe was due to the cranial shape of the ruling classes of the north being composed of "brachycephalic individuals" (i.e., short-headed), while those of the south were "dolichocephalis individuals" (i.e., long-headed). Likewise, Huntington (1924, p.411) argued that it was climatic conditions by way of "climatic handicaps" that inhibited economic growth; maximum growth occurring in temperate regions with moderate seasonal variations. He suggested that "climatic monotony" (such as that experienced in Southeast Asia) inhibits creativity and innovation. Markham (1947, p.29) followed this line of thought by concluding that the ideal climate to promote economic growth includes temperatures between 60°F and 76°F, and relative humidity at noon between 40 percent and 70 percent. These theories lost credibility with the post-World War II explosive development of many of the countries of Asia, who were burdened with the wrong cranial dimensions, as well as hot and humid climates.

By the 1990s, the World Bank (1993, p.26) was arguing that the quality of government was the major contributor to economic development by way of the "pragmatic adherence to the fundamentals", including low inflation, sound fiscal policies, high savings rates, and high levels of investment in education. It is a view that accounts for both present and future fundamentals, maintaining a focus on sustainable development.

Schumpeter (1934) was perhaps the first to link economic development to small business by suggesting that development is rooted in innovation. He perceived the entrepreneur (rather than the capitalist) as the linchpin of economic growth, and the role of government to support the innovative activities of the entrepreneurs. Porter (1990) later argued that domestic demand and domestic rivalry at the small business level ultimately leads to competitive clustering, consolidation, and stimulation for international competitive advantage. Indeed, Klapper and Delgado (2007) empirically found a strong positive relationship between business density and per capita GDP in a study of 84 developing and industrial countries.

In Sub-Saharan Africa, 80 percent of firms are small (IFC 2006), so it is obviously not merely the proliferation of small businesses that creates economic growth. To this end, Spencer and Gomez (2004) confirmed a negative relationship between per capita GDP and the percentage of small firms in a country. It would appear that the proliferation of small business is a characteristic of less developed countries that lack the economies of scale provided by a considerable large firm sector. In addition, the general marginal profitability of small businesses in Africa means that employees are most often paid very low wages, which, while alleviating absolute poverty, contributes to low productivity and poverty stricken households.

Indeed, there appears to be a number of enabling conditions that must be present before the small business sector can contribute to the economic development of a country. For example, van Stel *et al*. (2005) found that entrepreneurship negatively impacted on GDP growth for developing countries. They postulated that, in developing countries, small business owners are confronted with an uneducated workforce, marginal profitability, and low levels of innovation, all of which influence the development of small businesses into large, and envelop the country in a "poverty trap" (Sachs 2005).

In the case of Ethiopia, a number of recent studies have pointed to such factors as unfair competition from the informal sector, poor access to land and infrastructure, lack of access to finance and requirements for collateral, low productivity of human resources, inequality in tax administration, and corruption, as constraints on small business, and hence, inhibitors to the economic development of the country (Amin 2007; World Bank 2003; Hansson 2004; Kellow 2007).

This section has provided the theoretical background for the link between small business, entrepreneurship, and economic development, within which government plays a pivotal facilitation role. It is in the context of this theoretical background that the constraints to small business in Ethiopia will now be set.

5.0 METHODOLOGY

The sample consisted of 10 small business owner-managers in the retail clothing industry in Addis Ababa. Following the work of Bigsten and Gebreeyesus (2007) and Daniels and Mead (1998), a 'small business' was defined as one that employs 10 or fewer people. The businesses were involved in the retailing of clothing items. The owners purchased their stocks from importers and wholesalers, mostly located in the Merkato area of Addis Ababa.

The respondents were interviewed in the Amharic language using a semi-structured questionnaire; the responses were subsequently translated by the Ethiopian research assistant. The interview questions focused on the following basic issues:

- The main expenditure items for the business;
- The problems most affecting business operations and profitability; and,
- Changes the respondents believed were required to be implemented to alleviate the mentioned problems.

6.0 RESULTS

Retailing clothing stores in Ethiopia are generally referred to as 'boutiques'. The majority of the boutique owners (approximately 80 percent) were *Gurage* (goo-rah-gay). They belong to one of Ethiopia's ethnic groups, comprising 4.3 percent of the total population (CIA Factbook – Ethiopia 2008) and come from a mountainous area about 150 kilometres southwest of Addis Ababa. The *Gurage* are well-known for their work culture and skill as traders (Ford 2008). They typically have small farms in their villages, and often leave to secure a better living standard by way of retail trade in the major cities. The strong family affiliation of the *Gurage* contributes to the working culture. For instance, when a family member moves to Addis Ababa, they will pre-arrange a working environment for those family members that follow. In general, they often start with economic activity in the informal shoe polishing sector. They will then save their earnings, and open a small shop. In time, the small shop is improved and expanded by way of the capital investment of profits.

The boutique owners were predominantly aged 15-29; not only the owners, but also the employees. Most were unwilling to report the exact annual sales or annual expenses of their stores. The reason for their reluctance is that small businesses in Ethiopia generally maintain a set of accounts that understates sales and overstates expenses to minimise taxation obligations; on the other hand, they generally have little grasp of the true financial situation.

The boutique owners generally agreed on a number of common constraints that continue to affect their business operations and profitability. These are discussed next.

6.1 Human Resources

The respondents were well aware that lack of education was a major impediment to the success of their businesses; lack of education in management skills for themselves, as well as lack of basic education for their employees.

6.2 Corruption: Government Customs Authorities

The enabling environment is always an important component of business effectiveness in any country (Trulsson 2002). In Ethiopia, the government customs authority is a major polemic in the retail clothing industry. Transit time of goods through the customs process is heavily dependent on graft payment. Traders are forced to make corrupt payments because delay to market may mean that other suppliers saturate the market with similar products.

In addition, smuggled contraband negatively impacts on the retail clothing sector. The problem is that all traders do not pay equal tariffs and taxes for the imported goods, as required by law. For example, a trader may import three 20-foot seatainers, but by graft payment to certain customs officials, pay import tax for only two seatainers. The products contained in the other will reach the marketplace tax free, enabling the trader to undercut competitors by selling below the going market price, and negatively impacting on the businesses of those traders who lack access to corrupt officials.

Another problem for the retail clothing industry is the mixing of new and secondhand clothes. This is a particularly salient issue in rural areas where customs control is even weaker and more corrupt than in urban centres. The secondhand clothes are obtained corruptly from donated clothing items from developed countries, mixed with new clothes, and sold at a price below the going market value. Rural poverty provides a ready demand for low cost and low quality goods.

6.3 Corruption: Private Economic Activity by Government Employees

Government employees (e.g., customs authorities) are often involved in economic activities in competition with private enterprise. Indeed, a number of boutiques were reported to be owned by Government officials. Their competitive advantage rests in paying no import tax, thus, undercutting the prices offered by formal traders.

6.4 Inflation Rate

The inflation rate in Ethiopia is high; 16 percent in 2007 (CIA Factbook – Ethiopia 2008). As a result, in recent years, the purchasing power of the Birr (Ethiopian Currency) has declined markedly. In contrast, incomes have generally failed to rise as an offset to the high inflation rate. The main reason for the high inflation in recent years is the price of fuel. Previously the government subsidised fuel prices to some extent as a social welfare initiative. This subsidy has now been removed.

In terms of discretionary spending, the respondents indicated that consumers were now spending, both proportionally and in real terms, more on food and less on clothing. In addition, shop rents are continuously increasing. While the owner of the property and the trader may initially agree on a rental amount for the year, the property owner may unilaterally increase this amount during the year because of unforeseen expense increases. Rising prices has also seen a shift in customer preference for clothing items. For example, the respondents indicated that there has been a marked shift in preference from clothing manufactured in Turkey to that manufactured in China, since the Chinese product is considerably cheaper. In the previous two years, inflation has increased prices by over 30 percent, while during the same period, salaries have barely changed. Changing demand is increasing the pressure for low cost and low quality goods.

6.5 Price Setting

The method of price setting in small business in Ethiopia varies considerably between sector. Overall, the most common methods are mark-up pricing (44 percent), charging the going market price (36.3 percent), and negotiation/haggling with the customer (11.3 percent) (Amha & Ageba 2006). However, in the retail clothing industry negotiation/haggling dominates price setting. Almost all of the traders interviewed suggested the pricing system for retail clothing is not efficient because of the inconsistency of income and profit. Traders are able to take advantage of some customers who are not savvy about the product quality, and hence, make considerable profit on the sale. However, when dealing with customers who know the product very well, the profit margin may barely cover costs. Furthermore, many traders do not know the true cost of their clothing, and hence, maintain only a loose grasp of their profits. Lack of education is a major contributor to this problem.

6.6 Financial Management

Short-term and long-term financing is often problematic for firms in Africa. Liquidity is often in short supply and savings inadequate. Firms, therefore, require access to lines of credit, in the short-term, to purchase supplies, and in the long-term, for capital investment (Trulsson 2002). The retail clothing industry in Addis Ababa is no exception. Lack of credit is a major constraint reported by the traders. Bank finance is often beyond the reach of small business owners. The Government provides financial assistance, but only to a maximum amount of 5,000 Birr (US$550), and only after a long processing period. On the other hand, government employees moonlighting with private economic activities were reported as having easy access to government funds. The reports by the respondents in the study align with Amin (2007, p.37), who noted the privileged access to finance of "party-affiliated firms".

6.7 Market structure

In the retail clothing industry, the nature of the business does not require a highly educated person. Therefore, anyone with a small amount of capital may open a boutique. In the context of imitation with little innovation, this has the unfortunate consequence of increasing competition, while reducing both market share and profitability of all boutiques. The respondents mentioned the problem of imitation as a major impediment to their future prosperity. For example, they noted that a person may open a new café in a less populated district. If their business becomes successful, a new café will soon open, perhaps next door. The new café forces prices down, but because the owner is most likely uneducated, to a point at which neither café is able to operate profitably. The same applies to most industries, including boutiques.

7.0 DISCUSSION AND CONCLUSIONS

The purpose of this study was to explore constraints on small business in Ethiopia. The study, while focused on the retail clothing industry in Addis Ababa, presents a number of findings that are tangibly applicable to the business context of Ethiopia as a whole.

The present study identified the *Gurage* (goo-rah-gay) people as the 'minority entrepreneurs' in Ethiopia who maintain a business advantage because of their acquired traditions based on strong family bonds. The significant role of minority entrepreneurs in African economies has been noted by a number of scholars (see, for example, Ramachandran & Shah 1999). However, although significant, the role has limitations in terms of sustainable economic development, firstly, because it fosters ethnic division, and secondly, because it encourages the continued proliferation of small firms unable to exploit economies of scale (Fosu *et al*. 2001).

Consistent with previous studies (see, for example, Amin 2007; Hansson 2004; Kellow 2007; UNCTAD 2006; UNCTAD 2007; World Bank 2003), this study found a number of constraints on small business in Ethiopia. These constraints include a lowly educated workforce, rampant corruption of government officials, high inflation, lack of business skills, lack of access to finance, and dysfunctional competitive practices. These issues continue to create an impediment to entrepreneurial activity, and the economic growth of the country.

As Kristiansen *et al*. (2005, p.367) noted of developing countries, the unemployed are attracted to an industry and location by perceptions of the business success of others. Respondents to the present study suggested that this was certainly the case in Ethiopia. Furthermore, a dearth of information about economic alternatives, as well as lack of education and capital, prohibit individuals from engaging in industries with higher entry barriers, and hence, results in dysfunctional competitive practices. Consequently, in Ethiopia, imitative businesses predominate over innovative entrepreneurial activity, and contribute to the shared poverty of the country. While small business is often touted as the mechanism to raise a country from the "poverty trap" (Sachs 2005, p.19), in reality, poverty produces a vicious circle that envelops both consumers and suppliers, each securing the poverty of the other.

The World Bank (1993) was right in suggesting that the quality of government was the major contributor to economic development by way of the "pragmatic adherence to the fundamentals". However, the role of Government is far more complex than merely adhering to a set of 'fundamentals'. The internal entrepreneurial activities of a society, and the external economic pressures of global commerce, weave a complex web of fundamentals and enabling conditions that must all be balanced to achieve economic prosperity for citizens. The present study shows that the Ethiopian government has generally performed poorly on the fundamentals, such as inflation, fiscal policies, and investment in human resources; nor has the government performed effectively on the enabling conditions, as evidenced by the rampant corruption of its own officials and the proliferation of dysfunctional competitive practices, all of which severely impede entrepreneurial activities. Until these constraints are resolved, Ethiopia will sadly remain one of the poorest countries in the poorest region of the world.

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