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Financing Preference for MSMEs in Rural Tanzania

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ABSTRACT

The purpose of this study is to determine factors and identify the preferred type of financing among small business in rural areas in Tanzania. Written survey was used for data collection and the sample size was 102. Quantitative method was used to test the financing preference. It was found that business expansion (54%) and family obligations (32%) were the determining factors for external financing in the developmental stage. In the start-up stage of the business, the study finds that business owners preferred internal financing (61.7%) from their own savings for financing business. In the developmental stage, they preferred external borrowing from Savings and Credits Cooperatives Societies (SACCOS) (*W = 161.8*), banks and other MFIs (*W=57.2).* The small business owners' views SACCOS as most preferred type of financing due to its accessibility and impact on their businesses. The study concludes that internal and external funding is the backbone of rural MSMEs' financing in Tanzania. We recommend authorities to strengthen rural SACCOS to bring significant impact on rural business development.

Key word: Micro and small rural business, financing preferences, business cycle

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1.0 INTRODUCTION

In recent years Tanzania has witnessed the growing trend of Micro Small and Medium Enterprises (MSMEs) whereby the majority of them were established after the year 2000 (Liheta, 2016). Given their nature and characteristics of productivity, MSME is the main contributor to the economic development of many developing countries. For instance, it is estimated that MSMEs creates approximately 80% of new jobs in Canada and account for more than 63% of the GDP in developing countries (Ayyagari et al, 2005). In Tanzania, the sector employs over 33% of the labour force and it contributes to 27% of Gross Domestic Product (GDP) (Finscope Survey, 2012). There are about 3.16 million MSMEs in Tanzania whereby 54 percent of these operate in rural areas (Finscope Survey, 2012). It is estimated that 54% are owned by women and 46% by men (Finscope Survey, 2012). The role of MSMEs in Tanzania cannot be undermined as far as these enterprises create beneficial links between the non-farm economy and agricultural activities to alleviate rural poverty (World Bank, 2007).

There is a general consensus that access to finance and lack of collateral limit MSMEs in developing economies. To leverage resource challenges MSMEs in Tanzania prefer multiple loans (Finscope Survey, 2012; Mpogole *et al.*, 2012; Chalu and Lubawa, 2014; Lubawa & Louangrath, 2016). Despite of these efforts, however, the sector still faces challenges in accessing financial credit. These challenges include poor managerial skills, lack of skilled staff, uncontrolled growth, lack of government business support services, serial and historical traditions, high cost of inputs, advocacy capacity, inadequate quality control, and cultural environment (Cook & Nixson, 2000; Finscope Survey, 2012; Mbura, 2013). Rural areas are expected to face more challenges than urban business due to nature of poor business environment, risk credit market, poor infrastructure and the structure of rural economy. Kira and He (2012) observed that firms located in urban area in Tanzania have a higher possibility on access to loan or debt financing than firms located in rural area.

Despite contributions made by MSMEs toward economic development, the sector in Tanzania still faces the financing challenge (Mori et al, 2009, Finscope survey, 2012). This study investigated the most preferred type of financing and its reasons of funding MSMEs at start-up and development stage among business owners in rural Tanzania.

A sample of 102 small businesses was used. This paper examined the following issues: the start-up capital, age of the firm, owners' age and education level, reasons for external financing and the financing preferred sources in the growth period. The result from this study is expected to serve as a guideline to regulatory authorities on how to provide sustainable financing to small business in the rural regions.

The paper is divided into five sections. Section two reviews small business structure and financing in Tanzania, current sources of finance, and the finance issues and constraints faced by small businesses. Section three discusses theory relevant to small business financing. Sections four analyse the survey results and compare them to prior studies. The final section presents policy implications of the research.

2.0 MSME STRUCTURE AND FINANCING IN TANZANIA

The definition of MSMEs varies from country to country and from sector to sector. In Tanzania, the SMEs development policy of 2002 defines a micro, small enterprise as one with capital investment of between Tanzanian shillings (TZS) 5,000,000 and 200,000,000. According to the Small and Medium Enterprise Development Policy of the Government of Tanzania, the size categories of small businesses are defined through the number of employees and the capital investment in machinery (see Table 1).The number of employees includes the working business owner and manager. According to Tanzania Revenue Authority (TRA), SME is one whose annual taxable turnover is less than Tanzanian shillings 40,000,000. It should be noted that when an enterprise falls under more than one category (e.g., one employee but capital investment greater than TZS 5 million), the level of capital investment is the deciding factor in determining the size category. Schreiner and Leon (2001) pointed out that, a comprehensive definition of microenterprise should have three components namely; type of activity, investment limits, and number of employees. However, the definition of a 'small business' used in this study was taken to include all enterprises with capital investment of up to Tanzanian shillings 200,000,000. Based on SME policy, categories of SME definition in the country are classified as follows:

Table 1: Government of Tanzania's categorization of business size

Types of business	Employees	Capital Investment in Tanzania shillings
Micro business	1- 4	Up to 5 million
Small business	5 - 49	Above 5 million to 200 million
Medium business	50 - 99	Above 200 million to 800 million
Large business	100 +	Above 800 million

Source: URT Ministry of Industry and Trade (2003); 1 US$ is equivalent to Tanzanian shillings 2237.30 in April, 2017).

According to Finscope survey (2012), Tanzania has significantly more micro enterprises than small or medium sized businesses in all broad sectors (Table 2).

Table 2: MSME broad sector allocation by enterprise size

Size	Total	Trade	Services	Manufacture	Others
1 to 4 employees	3,074,736	1,710,884	942,596	406,426	14,830
5 or more employees	88,150	40,012	21,639	23,965	2,534

Source: Finscope survey (2012).

Finscope survey shows that (2012), there were about 2,754,697 people in Tanzania who owned and ran a micro, small or medium size business. While 86.2% of the small businesspersons owned and ran only one business, the rest owned and ran two (12.8%) or more (1%) businesses. In total, all MSME owned and ran about 3,162,886 MSMEs. About 96.4% of small business owners were sole proprietors, and about 3.5% were in partnerships in which 77% of all partners were related. About 1, 459, 167(53%) Small business owners are found in rural areas. About 80.6% of all small businesses had a business name, while only 3.9% of small businesses were registered under Business Registrations and Licensing Agency in Tanzania (BRELA). Although the majority of small businesses were not registered under BRELA many still held other licenses (e.g. Trade license, Professional registration, Local authority license, Daily license) that indicate some degree of formality, (see Table 6.6). A few small businesses had a tax identification number (TIN) for the business that may also serve as an indicator of formality and hence paid several taxes and levies, as shown in Table 3.

Table 3: Taxes and levies paid by MSMEs by area (%)

Item	Total	Dar Es Salaam	Other urban	Rural areas	Zanzibar
Income tax	5.2	7.7	8.2	2.8	14.6
Property tax	2.0	4.2	3.2	0.7	6.6
VAT	2.5	3.0	4.5	1.3	17.3
PAYE	1.4	3.1	1.3	2.3	2.5
NSSF/ZSSF	0.2	0.6	0.3	0.0	0.1
Excise levies	0.2	0.6	0.2	0.0	0.0
Other taxes/levies	2.2	4.1	3.6	1.0	8.8
Skills development levy	1.9	3.6	2.9	1.0	4.4
Unofficial" levies	0.9	2.0	1.4	0.3	3.3
Electricity/ water levies	3.0	6.0	6.0	5.2	9.5

Daily taxes	0.9	2.1	1.3	5.5	5.5
Business license	0.1	0.1	0.1	0.1	0.0

Source: Finscope survey (2012)

Finscope (2012) found that the motivation for starting a business for most MSMEs' owners originated from their need to support their families or to supplement their incomes. Less than a third of small business owners cited their achievement as a motivation for start-up. Two-thirds of small businesspersons were mostly motivated by the financial benefits they expected to generate. Before they started their business, many male small business owners had run a small business in another sector that gave them at least some small business experience. However, most of them were hampered by capital constraints.

Finscope (2012) also indicated that the highest level of education achieved by MSME owners is primary school, with male business owners generally obtained higher levels of education than female owners; this was particularly pronounced in rural areas. However, education has been partly improved through attending short training courses after their formal education. Consequently, most small businesspersons regarded themselves as either unskilled or semi-skilled (Finscope survey, 2012). MSMEs' owners were found in all age groups, with the greatest concentration in the 25-34 year old group (Table 4).

Table 4: Ownership by age groups and gender (%)

Age group	**Total**	**Male**	**Female**
Under 25 years	11.0	10.4	11.6
25 to 34 years	36.0	38.4	34.2
35 to 44 years	30.7	29.4	31.8
45 to 54 years	15.5	15.4	16.0
55 years and above	6.8	6.8	6.4

Source: Finscope survey (2012)

Small businesses are considered as important foundation for the growth of private sector in Tanzania in term of job creation, income generation, feeding inputs to large-scale industries, development of domestic technology, utilization of local resources and stimulation of growth in both urban and rural areas (Liheta, 2016). Through business linkages, partnership and sub-contracting relationships, small businesses have a great potential to complement large industries. For a developing country, a strong and productive industrial structure can only be achieved where small and large enterprises co-exist and work in partnership.

In Tanzania, small business enterprises are found in food processing, textiles, edible oil production, woodworks enterprises, retail shops, etc. that requires simple technology and local raw materials are abundant. These enterprises help to encourage the use of local resources for its production and thus can create a self-reliant economy. Small firms are also serving as ancillaries to large firms by providing parts, components, and accessories (Liheta, 2016). According to Finscope Survey (2012), the majority of small business owners started their business to support themselves financially and few of them were driven by entrepreneurial motives.

An adequate financing for small business is important in every stages of business cycle. However, in practice, the microfinance interventions are accessible only to the small businesses already existing in the market and ignores the new entrants in the market particularly those in the rural areas who are looking for start-up capital. They forget that no business entity, whether large or small, can be incorporated, established and expanded without adequate start-up capital. For most small businesses in Tanzania, start-up capitals are funds provided by the start-up team, family and friends, prior to and at the time of the inception (Mpogole et al, 2012; Chalu and Lubawa, 2014).

The literature confirmed that small business owners' tend to rely heavily on their past savings, followed by informal sources of credit from family or friends, particularly at business start-up stage (Aryeetey et al., 1994; Paul et al., 2007; Osei-Assibey et al, 2012). the longer firms stay in business operation, the more it signals that it can weather tough economic conditions Chandler (2009), and that the use of external debt financing particularly bank loan becomes more common and most preferred once the business is up and running (Wyer et al., 2007). Berger and Udell's (1998) financial growth model, shows that small business have a financial growth cycle in which financial needs and options change as the firm starts-up, grows, gains further experience and becomes more transparent with its information. As firms continue to expand, they could access to public equity and debt markets. However, in order to start or grow any form of business, financing is essential. There are various sources of financing available to small firms, depending on a variety of factors. In Tanzania, small business can raise funds through formal and informal financial institutions. Through a review of previous studies on MSMEs financing in Tanzania, we found that most of studies identified the following financing sources for small business in Tanzania;

2.1 Internal sources of financing

Internal financing or self-financing comes from individual saving it is constrained by the low savings capability arising from low incomes. Usually, most savings are held in no monetary forms, such as livestock, grain, maize and other such trees and land, though it could be also as the accumulation of cash. It should be noted that savings in rural Africa is often not clearly distinguishable from investment or consumption, particularly where it involves animals or consumables (Liheta, 2016). It can be argued that savings is a source of equity financing (self-financing) to most of small businesses. Frederick et al (2006) and Cassar (2004) explained that equity financing is the best financing option for starting a business. It should be noted that, small businesses tend not to go for equity financing from the public in order to keep the original of ownership (Fredrick et al, 2006), and due to cost burden (admission fees, advisors and broker commissions), lack of education about the process of listing (Nassr and Wehinger, 2015).

2.2 External sources of financing

As the business grows, the trade-off theory states that a firm can derived optimal debt ratio through a trade-off between cost of bankruptcy and tax advantage of borrowing (Scott, 1997). The higher the profits, the lower the expected costs of financing distress and hence the business would prefer debt financing over equity. Although the theory is commonly applied to larger firms; however, its usefulness is also important in small firms. Myers (1984) and Fazzari et al (1988) argued that small business will choose external funds than internal to normalize its business investment if larger cash flows are needed.

In Tanzania, microfinance scheme is a major external funding source for most MSMEs. The scheme provides microcredit to small businesses that are not acceptable by the commercial banks due to lack of collateral. The microfinance scheme tends to use the credit methodologies that simply employ collateral substitutes and innovative recovery practices. The credits methodologies provides terms and conditions that are flexible and easy to understand and are suited to MSMEs (Liheta, 2016).

2.3 Microfinance Institutions (MFIs) in Tanzania

Tanzania has many Microfinance Institutions (MFIs) that give loans to small businesses. The majority of these MFIs were started when the government developed the National Microfinance Policy in line with financial sector reforms in 1991. The National Microfinance Policy was launched on February 2001 with key objective of establishing a basis for evolution of an efficient and effective micro finance system that served the low-income segment of the society. The policy also spelt out the national vision for the development of Micro finance as a tool for poverty eradication through the widespread access to micro financial services across the country, on a commercially sustainable basis, thereby contributing to the economic growth of Tanzania. Since then MFIs in Tanzania has been providing financial services to the unbankable community in the rural and urban areas. Some of the services offered by MFIs are; macro savings, micro credits, micro insurance and money transfer. MFIs in Tanzania have created several impacts to beneficiaries. Some scholars report positive effects of MFIs; for instance; some studies revealed the increase of clients' expenditure, accumulation of assets, improvement of health, education, food security, nutrition and business growth for the poor(Kessy and Urio, 2006; Kessy and Temu,2009; Stewart et al,2010). Other studies report adversely, such as confiscation of borrowers' assets which might lead to poverty, and sometimes stress and mental burden, increase of workloads for women (Nghiem, 2009; Mpogole et al, 2012; Kato and Kratzer, 2013). In general, MFIs have been the major success for the business to compete and for poverty alleviation (Christopher, 2008). Although their reach to broader population and small scale businesses is still limited due to concentration of MFIs in selected regions.

The followings are MFIs operating in Tanzania apart from SACCOS which dominant group among MFIs, other MFIs dominant in issuing loans to small businesses are; Foundation for International Community Assistance (FINCA),Small Industries Development Organization (SIDO), Promotion of Rural Initiatives and Development Enterprises (PRIDE - Tanzania), Small Enterprise Development Agency (SEDA), YETU Microfinance, financial Non-Governmental Organizations (NGO), and Savings and Credit Associations (SACAs). Other MFIs are; Bangladesh Rural Advancement Committee (BRAC), Microenterprise Development Agency (MEDA) and BAYPORT.

There are also commercial banks which have down-scaling of their commercial services offered so as to allow provision of microcredit similar to what is currently offered by MFIs. These banks are: The National Microfinance Bank (NMB Plc), AKIBA Commercial Bank, CRDB Plc, Tanzania Postal Bank and Equity Bank Tanzania. The NMB encourages and expands microfinance in three ways; (i) Loans to micro and small enterprises for the purchase and inventory and supply of goods, (ii) Collection and payment services to large corporate clients to/from micro and small enterprises and (iii) add-on services such as money transfers and payroll services to both the large corporate clients and micro and small enterprises. AKIBA currently offers several microfinance loan products tailored to suit every type of customer. The microfinance products offered at AKIBA are savings deposits, group (called Solidarity Group) and individual microenterprise loans (called Biashara Loans). CRDB is a more conservative bank reduces its risks in microfinance by loaning to groups such as SACCOs instead of micro and small enterprise borrowers. CRDB provides SACCOs with financial stability.

The Tanzania Postal Bank (TPB) is also the commercial bank that is involved in microfinance. The TPB was created by an Act of Parliament and is under the Companies Registrar and under Tanzania Postal Bank Act No.11 of 1991 as amended by Act No.11 of 1992. The bank provides microfinance services to Small and Medium Enterprises (SMEs). These are small and medium size loans available to Small and Medium Enterprises to support their financial requirements including enhancement of working capital and financing investment related activities. The objective is to expand business operations and grow their profitability to become viable and sustainable businesses. The facility may be issued in form of an installment loan or an overdraft facility. Equity Bank Tanzania also provides Micro Business Loans (e.g.group loan that is a credit product specially designed for group borrowers or customers with micro businesses) and SME-Business Loan (available to SME's operating in Transport, Trade and Commerce, Construction, Manufacturing, Education, Health and other service sectors). However, most banks and other financial institutions in Tanzania are located in urban areas (Facet, 2011) that that results in difficulty in accessing microfinance service by small scale businesses in rural areas (Wangwe & Lwakatare, 2004).

In rural Tanzania, there are semi-formal microfinance institutions and Non-governmental organizations providing microfinance services (Nyamsogoro, 2010; Facet, 2011). Savings and Credit Cooperative Organizations (SACCOs), RoSCAs, SACAS, the Village Savings and Loan Associations (VSLAs), Village Community Banks (VICOBA) and community conservation banks (COCOBA) are some examples of semi-formal microfinance institutions. The semi-formal microfinance institutions in rural areas are made up of farmers and non-farm members offered micro credit provision to members only. The credit can also be granted in financing basic needs like education, agriculture and health. They provide savings and internal lending for communities (Facet, 2011; Randhawa & Gallardo, 2003; Rubambey, 2005). The study by Flora (2015) shows that small scale businesses in rural Tanzania have access and benefited from microfinance services from different MFIs.

SACCOS are co-operatives microfinance institutions using co-operative values and principles in provision of financial services. SACCOS are dominant in microfinance market. They are owned, governed and managed by its members. They usually require membership fee, and/or share capital or obligatory savings from all members (Liheta, 2016). In Tanzania, they are regulated and supervised by the co-operative act. Since became in operations, rural SACCOS in Tanzania have great assisted in addressing the financing problem for rural borrowers (Wangwe, 2004; Kessy and Urio, 2006; Kessy and Temu, 2009; Qin and Ndiege 2013). The Ministry of Finance of Tanzania reported that until March, 2013 in country the number of registered SACCOS was about 5346 while amount loaned reached shillings 627.2 billion in 2011(MOFT, 2012; 2013). Since their formation started in the 1980's, after the adoption of the free market liberalization policies, SACCOS has been very important microfinance institution to community. Literature evident that SACCOS are very helpful MFIs in serving rural Tanzania where most of people are unbankable Wangwe (2004). A Study by Bwana and Mwakujonga (2013); Quin and Ndiege (2013) found that SACCOS contribute to about 40% of the Tanzania's GDP and play important roles for financing small and medium enterprises in the rural areas. Magali (2013) also realized that rural SACCOS improved the livelihood of members on education, health, physical assets, crop yields and business capital. SACCOS play vital role in boosting the social-economic development of rural areas.

2.4 Sources of Financing by Life Cycle Stages

Like small firms around the world, micro and small business in Tanzania also undergo several stages from inception to maturity. This life cycle begins in the developmental stage through various stages of revenue growth. However, these stages depend on economic environment surrounding the firms. Berger and Udell (1998) asserted that the particular phase of business's life cycle determines the nature of its financial needs, the availability of financial resources and the related cost of capital. Micro and small businesses are thought to have a financial growth cycle in which financial needs and options change as the business grows, gains further experience, and become less informational opaque. Table 2 shows life cycle stages, types of financing for each stage, sources of financing and entrepreneurial process activities.

Table 2: Sources of Financing by Life Cycle Stages

Life cycle stage	Types of financing	Major sources/players	Entrepreneurial process activities
Development	Seed financing	Entrepreneur's assets Family and friends Bootstrapping	Developing business idea Developing opportunities
Start-up	Internal financing	Internal funds Entrepreneur's assets Bootstrapping	Gathering resources Building operations

Expansion	External financing	Business operations Suppliers and customers Obtaining MFIs loans	Managing and building operations
Maturity	External financing	Business operations Suppliers and customers Obtaining MFIs loans	Managing and building operations

During the developmental stage of a business's life cycle, the primary source of funds is in the form of seed capital to determine whether the idea can be converted into a viable business opportunity. The primary source of funds at the developmental stage is the business owner's own assets and sometimes financial bootstrapping; that is, creative methods, including barter, to minimize the cash needed to fund the business (Leach and Melicher, 2010). In the business start-up stage, it is a common practice for micro and small business owners to use internal funding capital in order to minimize financing cost (Berger and Udell, 1998).

2.5 Constraints Faced By Small Business in Tanzania

Most commercial banks consider SME's as risky borrowers. Nyamsogoro(2011) on his study on "factors influencing financial sustainability of rural microfinance institutions in Tanzania", concluded that; microfinance capital structure, interest rates, difference in lending types, loan repayment plan, cost per borrower, product type, microfinance size, and the number of borrowers are significant factors affecting rural microfinance institutions in Tanzania. Based on these facts, one may assume that, providing financial services to the rural area has always remained a challenge to MFIs due to the inherent difficulties associated with low population density, seasonality, isolated markets, lack of adequate physical and human infrastructures (e.g. roads, electricity, poor telecommunication services and limited technology, education and health), that's why most of MFIs in rural are small, of which are member-based cooperatives, (e.g. SACCOSs and SACAs). Finscope-Tanzania survey (2012) reported that majority of adult population in rural areas do not use banks products and only 18.4% of the population are covered by formal financial institutions. Kira and He (2012) pointed out that among other factors associated with firms' characteristics that have impacts on small business is access to external financing from different sourcing of financing in Tanzania are, age of firm, and location. According to Kira and He (2012) firms located in urban areas in have a higher possibility on access to debt financing than firms located in the rural area and that older firms find easier to access debt financing than younger firms. The study also found that firms located in urban areas have higher possibility on access to loan or debt financing than firms located in the rural area. It has also been suggested that participation in entrepreneurial activities is influenced by level of education (Peter, 2001), and that people with a low level of education have more difficulties finding a paid job and; therefore, see no other possibility than to be self-employed in entrepreneurship (Wit & Van 1989). Olomi (2005) pointed out that those who unable to find jobs in the formal sector end up in the informal sector whereby MSMEs are dominating. This is a crucial issue to be concerned particularly in Tanzania where about 80 percent of the population are in rural location and are excluded from banking services (Rubambey, 2005).

Most entrepreneurs in rural areas are faced with financial illiteracy, awkward geographical location (require special journey) and temporal constraints in accessing formal financial services. Berger and Udell (2002) pointed out that the geographical closeness between lenders and customers has significant association for customers to access loan. The MFIs which are geographically close to MSMEs are capable of utilizing soft available qualitative information for credit analysis and evaluation. To address these challenges, saving-up strategies come in especially where the other mechanisms are not available. Savings are accumulated amount of money in a safe place at home (home box) until they have grown into a useful large sum (Rutherford, 1999). Savings as a micro-finance factor enable people with few assets to save, since they could make weekly savings, as well as contribute to group savings, and such savings are mobilized by the micro-finance institutions for further lending to other clients (Mkpado & Arene, 2007). Household saving at home is arguably the most relevant savings mechanism in Kilolo villages since it has no entry barriers, and has no transaction cost, and impose no interest charges (Kilolo District Council, Social Economic Profile, 2013). In a tribal language, this saving strategy is known as *"fiyite amapesa*" (that means savings the money in a secret place at home for future or emergency use). Using private savings does not bring additional obligations and the decision to use them can be made without reference to a third party. With savings approach, the terms of contribution range from a few days or weeks to many years depending on the entrepreneur's objectives mostly for business motivation. Traditionally, rural areas tend to build lump sums seasonality after the sale of harvest or animals (Kilolo District Council, Social Economic Profile, 2013). Other form of savings which is also prevalent in many rural areas of Tanzania is savings in-kind. This is when an individual opts to use physical assets as a store of value and use it in future when there is a need of liquid cash. This may take form of animals, maize, beans, and forest product. However, the saving method, whatever form it takes, is faced with higher risks like theft, produces are susceptible to disease, destructive tendency of moisture and damage by rodents and consumption to meet daily life cycle needs and unanticipated financing emergencies (such as illness, accident, funerals and fire). Thus, the use of personal savings for individual growth as well as contribute to group savings, and such savings are mobilised by MFIs for future borrowing to is linked to the Pecking Order Theory(POT). According to POT, (see Abor (2008) and Hussain and Matlay (2007)), the order of the preference is from the one that is least sensitive (and least risky) to the one that is most sensitive (and most risky) that arise because of asymmetric information between corporate insiders and less well informed market participants. This is because internal financing incurs neither security issuing or flotation costs nor disclosure of financial information and, thus no transaction cost. According to the POT, if the external financing is needed, then debt, which is associated with less severe information asymmetry, is preferred over equity issue. Financing decisions of MSMEs are better explained by the POT when faced with information asymmetry.

3.0 RELEVANCE OF PECKING ORDER THEORY FOR SMALL BUSINESS FINANCING

POT was developed for large public companies; however, it is equally appropriate to small firms because the 'Pecking order hypothesis' in keeping with the prior that external borrowing is by far the largest source of external finance for small businesses (Scherr et al,1990; Cassar and Holmes,2003). The issuance of new equity for small business is questionable due to nature of firm's characteristics. Most of these firms are family businesses, that small business' manager tend to be the business owners and they are not interested to dilute their ownership claim (Holmes and Kent, 1991, Jordan et al, 1998). This implies that external equity financing for small business is inappropriate. Ibbotson et al, (2001) argues that POT is more relevant for the small business sector because of the relatively greater information asymmetries and the higher cost of external equity for small business. The information asymmetry and agency conflicts are likely to arise in small business simply because of their characteristics, i.e. being controlled by individual or family or related people. Scherr et al, 1993 also noted that the costs of asymmetry are more evident for small business than for large publicly traded companies, making differences in costs between internal equity, debt, and external equity consequently greater. Therefore, POT financing preferences may be more relevant to small firms than large ones. The literature suggests that small business owners source their capital from a pecking order: first, their own money (retained earnings); second, short-term borrowings, as liquidity management of small business is crucial if the survival and prosperity of small business is to be ensured (Deakins et al, 2000; Sardakis et al, 2007); and third, long-term borrowing. The Pecking Order Theory developed by Myers and Majluf (1984) and Myers (1984) does not predict an optimal capital structure.

Against this background, rural MSMEs financing remains less studied area in Tanzania. Empirical evidence supports the applicability of the POT in explaining the financing of MSME which has been done in foreign countries where business environmental might be different from rural environment in Tanzania. Few studies in developing countries showed contradicting results. While some studies (e.g. Green et al, 2002; Gebru, 2009; Osei-Assibey et al, 2012) argue that MSME's financing preference generally conforms to POT, others (e.g. Murray and Goyal, 2003) have shown that POT fails where it should hold, especially for small firms where information asymmetry is a problem. Thus, little is known about rural context in Tanzania. The main objective of the study was to provide some preliminary descriptive evidence of rural MSME financing. This study, therefore, took the MSMEs in the wards of Ilula, Mtitu and Ruaha Mbuyuni in Kilolo District as a case study to investigate the rural MSMEs Financing Preferences: does POT hold? To achieve this end, a questionnaire survey was administered to a sample of 102 SMEs owners' in the target areas by examining issues including the start-up capital, age of the firm, owners' age and education level, reasons for external financing and the financing pecking order in the growth period.

4.0 STUDY LOCATION AND METHODOLOGY

The study was conducted in rural Tanzania in the District of Kilolo. The location was purposively selected for two major reasons. First, the presence of active microfinance institutions (e.g. SACCOS) likes other SACCOS in the country, where microfinance services have been growing rapidly (MBF, 2010). There are eleven (11) registered active SACCOS in Kilolo rural, whereby; only seven (7) SACCOS are operating have shown to be more active. A total of Tshs. 790,289,154 was deposited in eleven (11) SACCOs accounts by the year 2012. At the same time, a total of Tshs. 4,911,509,650 was credited to individual members in 2012. Second, despite the fact that there is a tremendous deposit in SACCOS, however, by the end of 2012, NMB, Tanzania Postal Bank and FINCA were the only financial institutions that were operating in the district (Kilolo District Council, Social Economic Profile, 2013), however, savings practices are still popular in the District.

In this study, data was collected in April / May 2016 by using a survey questionnaire which targeted small businesses. A sample of 102 entrepreneurs from three wards was included in the survey. All questions in the survey were close-ended to limit the respondent's answers to the survey questions and encourage their focus on the issue at hand. Descriptive statistical methods and employed to analyse and explain the data. Sample size was estimated by using the following formula (Amin, 2002).

$$n = \frac{Z^2\sigma^2}{E^2} \qquad (1)$$

where n = sample size; σ = estimated population standard deviation; and E = standard error determine by $E = \sigma / \sqrt{n}$ assuming confidence interval of 95% for the estimated population proportion, maximum error of 5%. A test sample of 30 was used to calculate minimum sample size according to equation (1). The result showed a minimum sample of 27 was required. A sample of 102 counts was collected for this study.

5.0 RESULTS AND DISCUSSION

5.1 Description of respondents

Respondents involved in this study were business owners from the selected areas. The results indicate that most of the respondents came from age of between 18 to 39 years (76%). The age is an indicative that people can have extra years of saving and accumulating a business capital. The findings are consistent to other studies by Tundui (2012); Chalu and Lubawa (2014), which noted that most of the small business owners in Tanzania were younger than 40 years. Other respondents were in the age group of 40-49(18%), and 50 years and above group was the smallest (6%). These were people born before 1980, this is the time where Tanzania followed socialism. The country embraced a state-controlled economy. There was no room for market economy due to dominance of Marxist-Lenninist oriented social, political and most importantly economic thinking. During this period, people experienced an anti-entrepreneurial educational, political, legal policy and regulatory environment where an attempting to create free private enterprises as more or less equivalent to being an enemy of the state. An indication that either the elderly people freely chose not to engage themselves in the small business due to poor entrepreneurial skills or thus debt market discouraged them to avoid risk of input repayments failure. This finding indicates that individual attributes (such as age) may play an important role in entrepreneurial activity. Education was found to be among the factors explaining the owners' financing preference. Generally, the results revealed that most of MSMEs' owners in rural areas possesses relatively low education, 50 percent of them had not completed secondary education. As expected, findings revealed that business owners with lower education level (60 percent) are interested to abide with explanations of Pecking Order Hypothesis, which exhausts all internal financing sources before opting for external financing. Educated MSMEs owners' are in good position to link between the risk and cost associated with source of financing mainly debt with intention of optimizing the value of the firm and which decides for an optimal capital structure. The results also showed that 46% of respondents owned business with capital of less than Tanzanian shillings 5,000,000.

In case of the age of the business, the results indicate that 46 firms (about 45.1%) have been operating for more than ten years. This is an indication that most of these firms can go on with operations due to experience on encountering challenges especially financial challenges. As more time passes and enterprise matures, reputation is built and confidence is gained, the desire for long-term growth and expansion becomes inevitable. Chandler (2009) pointed out that; the longer the firm stays in operation, the more persistence to unpleasant economic circumstances. It was expected that external finance would be preferred or desired from debt market, since the firms then become more acceptable to the markets. Firms with less than 5 years in operation are less likely to rely on debt financing from debt market (Klapper, 2010).

Table 3.1: Description of Respondents

Age(years)	**Frequency**	**Percent (n = 102)**	**Education**	**Freq.**	**Percent (n = 102)**
18-28	18	17.6	No formal education	27	26.5
29-39	56	55.0	Primary education	41	40.2
40-48	20	19.6	Secondary education	16	15.7
49 and above	08	7.8	Certificate or diploma	14	13.7
			Degree and above	4	03.9
Total	**102**	**100**	**Total**	**102**	**100**

Years in business	**Freq.**	**Percent (n = 102)**	**Size by Capital (TZS)**	**Freq.**	**Percent (n = 102)**
Less than one year	05	05.0	Below- 4,999,999	52	51.0
1 – 5 years	23	22.5	5,000,000 -	19	18.6

			9,999,999		
6 – 10 years	28	27.4	10,000,000 - 14,999,999	16	15.7
More than 10 years	46	45.1	15,000,000 - 19,999,999	11	10.8
			20,000,000 and above	04	3.9
Total	**102**	**100**	**Total**	**102**	**100**

Note: Percent = Frequency / 102

Respondents were also asked about the financial sources at start-up (see table 3.2). About 61.7 percent of them indicate that the key financial sources at the business start-up come from private savings, 21.6 percent borrowed from friends and relatives, 16.7 percent borrowed from MFIs and 0 percent from commercial bank and government support. This is consistent with other studies in foreign countries. For example, Bank of England (2003) data suggests that 60 percent of business owners used their personal financial resources and finance from family members as the main sources of capital to start their business. Berger and Udell (1998) pointed out that, at start-up, small firms tend to rely on initial finance from owner's savings, family and friends.

The findings confirmed that rural areas still are excluded from banking services due to strict requirements for accessing the funds from a particular financial institution: Formal business address, having a good, convincing and bankable business plan, having collateral, showing good business records, including sales, revenue and profit, indicating reputable referees, having to for loan processing fees, paying high interest rates and at times rough treatment in case of delayed payment or default. All these and many others factors are hindrances for the rural MSMEs to access finance. They are understandable from a business perspective, but they remain a necessary evil for small business. The findings also show that the Government support in rural area is still limited. Thus, private savings remains the only source of funds to most rural entrepreneurs due to constraints pose by the financial institutions in one hand and the rural accessibility in other hand.

We asked respondents to mention one major reason for external financing. Results show that business expansion (54%) was the major reason for rural MSMEs external financing. This is an indication that rural firms attempts to grow despite of all geographical and financial barriers. Family obligations (32%) ranked second after that of business expansion. This means that although they intended to take loans for business running, intentionally used for family obligations. This is an indication that rural entrepreneurs did not distinguish business from family matters due to low income. Olomi (2009), urged that the lack of distinction between family obligations and business itself in Tanzania has been persisted for quite some time. Other reasons reported were financing deficit (8%) and developed a new business (6%). we can conclude that innovation is still unthinkable to rural small businesses.

Table 3.2: Sources of Start-Up Capital and Reasons for External Financing by SME's Owners

Start-Up Capital			**Reasons For External Financing**		
Category	**Freq.**	**Percent (n = 102)**	**Category**	**Freq.**	**Percent (n = 102)**
Commercial bank loan	0.0	0.0	Business expansion	52	54
SACCOS /MFIs loan	17	16.7	Financing deficit	11	08
Government support	0.0	0.0	Developed a new business	06	06

Friends and relatives	22	21.6	Family obligations	33	32
Own Saving	63	61.7			
Total	**102**	**100**	**Total**	**102**	**100**

Note: Percent = Frequency / 102

5.2 Preference of financing in Growth Period

To test the Pecking Order Hypothesis during the growth period, a question was designed to solicit rural MSME's owners about their financial preference during the growth period of their firms. They were free to list their three financing preference sources as first choice, three sources second choice and three sources as third choice, by mentioning the names of financial source whether commercial banks, SACCOS/MFIs or and equity.

The choice of financing preferences entails an important decision for every firm whether public or private, large or small. In fact, considering its duration, amount and irreversible character, a financing decision is regarded as a major and strategic one. Therefore, the process of a financing decision should be conveniently modeled. For this growing stage, the multiple weighted scoring model (MWSM) was adopted. The model is the best known and simplest Multi-Criteria Decision Analysis (MCDA) method for evaluating a number of alternatives in terms of a number of decision criteria by screening, prioritising or selecting the alternatives based on human judgment from among a finite set of alternatives in terms of multiple usually conflicting criteria (Hwang and Yoon, 1981). We assume that all alternatives score with respect to all criteria are known or has been estimated by the decision maker.

According to multiple weighted scoring method, each financing preference is ranked by its relative importance (mapping scale) (Table 3.3).

Table 3.3: Financing Preference and Weighted Importance

Financing Preference	Importance weight (b_i)
1st Preference	3
2nd Preference	2
3rd Preference	1

Score for all choices (frequencies (f_i)) would be calculated using equation (2).

$$\sum_{i=1}^{n} f_i = f_1 + f_2 + ... + f_n \qquad (2)$$

where f_i = score in terms of preferences and or type of financing source i = 1, 2,…,102, and n = sample size (102).

Individual weighting values (W_i) for financing preference were developed according to equation (3). Multiply importance weights (b_i) by scores to arrive at a weighted score for each criterion (W_i). The computed sets of numerical weights determined the relative importance of the evaluation categories. Then the weighted scores are used to arrive at an overall project score: the final score for each project becomes the sum of all its weighted criteria. The highest weighted score ranked (R) as the most preferred financing by respondents.

$$W_i = \frac{\sum_{i=1}^{n} f_i b_i}{n} \tag{3}$$

where, W_i = weighted score for individual preference, i = 1,2,3,..., k, k = number of score for each financing preference, and n = sample size (102). The weighted score vector must satisfy the condition that:

$$\sum_{i=1}^{3} W_i = W_1 + W_2 + W_3 = 1 \tag{4}$$

where, W_i = weight of criterion financing preference either first, second or third choice and $W_i \geq 0, i(1,2,3)$.

Table 3.4 points out that the first financing preference by rural MSMEs follows the pattern SACCOS (161.8), Banks (57.2), Internal financing (56.7) and equity (0.0). Both SACCOS and banks are external financing. This proves that on growing stage the rural MSMEs financing strategies would prefer external debt over internal. The findings reaffirm POT to establish a hierarchy of financing preference.

The MSMEs owner's criteria for preferring SACCOS financing was that loans by SACCOS can lead to significance impacts on business. Its smoothing accessibility was another criterion. The accessibility was fair because the borrowing comes from client's contribution. The findings stressed the evident of Wangwe (2004) that SACCOS are important MFIs in rural Tanzania where most people are not served by formal financial institutions.

Table 3.4: Financing Preferences in growth period

Preferred Financing Sources									
		External Source				**Internal Source**			
Financing source		**SACCOS**		**Banks/ MFIs**		**Internal Financing**		**Equity**	
	b_i	**W_i**	**f_i**	**W_i**	**f_i**	**W_i**	**f_i**	**W_i**	**f_i**
	3	69.6%	71	17.6%	18	13.7%	14	0.0%	0
	2	25.5%	26	21.6%	22	23.5%	24	0.0%	0
	1	4.9%	5	60.8%	62	62.7%	64	0.0%	0
$\sum f_i$			102		102		102		0
$W_i = \frac{\sum_{i=1}^{k} f_i b_i}{n}$		**161.8**		**57.2**		**56.7**		**0.0**	
Creteria(C_i)		Accessibility, Positive impact on business		Difficult in accessibility, collateral demanded		Low package, low risk		Long period of waiting the dividend, Require huge capital for better returns	
Ranking		**1**		**2**		**3**		**4**	

Similar findings were reported in the study by Gebru (2009) and Osei-Assibey et al, (2012) in rural financing in Ethiopia and Ghana respectively. Both studies reaffirmed the POT to a hierarchy of financing preference. Furthermore, factors such as owner's age and level of education, age of business, size by capital, reasons for start-up capital were found to be major determinants of rural SME owners' financing preferences. In the presence study, we also found that these factors are also determinative for POT.

6.0 CONCLUSION AND RECOMMENDATION

In this paper, a number of issues surrounding rural MSME owners' financing preference in light of the Pecking Order Theory (POT) were investigated. The overall findings provide a significant support for the Pecking Order Theory. Factors such as start-up capital, age of the firm, owners' age and education level, reasons for external financing and the financing pecking order in the growth period are found to be major determinants of rural MSMEs owners' financing preferences.

We observed significant implications for the government and other stakeholders on rural development. The findings urge government and other policy makers to develop appropriate policies to resolve the problems of finance in the rural MSME sector. This requires the government and the banking sector to develop solid strategies to support rural MSMEs in financing. Moreover, the results also alert policy makers to re-examine the current credit guarantee institutional scheme in Tanzania, particularly SACCOS and give flexible attention to rural MSMEs. Possibly, rural MSMEs owners' could benefit from optimal capital structure education and financial management training.

This study was limited by the relatively small sample, nevertheless the research outcomes, , contributed to expanding the body of knowledge about rural MSME financing in Tanzania and could encourage further research on the role of financial management education to rural MSMEs owners', since POT was developed for large publicly companies and believed to be equally appropriate to small firms. However, the findings can also be used to provide basic information and stimulate discussion to on the need for a modified POT that could more reflect the special context of rural MSMEs financing in developing countries. We need to create an integrated rural financial system that is more responsive to varied financing needs of MSMEs at all stages. For developing economies, country's wealth depends on the vibrancy and dynamism of its MSMEs.

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