TOPIC 2: FINANCING SMALL-SIZED BUSINESSES

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2.1. THE CONCEPT OF SMALL-SIZED BUSINESS

SMALL BUSINESS

A small business is a privately owned and operated business that has a limited number of employees and a relatively low volume of sales or revenue compared to large businesses. Small business examples in Tanzania includes

— Retail shops (duka la rejareja)

— Food vendors (Mama Lishe/Baba Lishe)

— Tailoring and sewing services

— Poultry keeping

— Bodaboda or Bajaji transport services

CLASSIFICATION OF BUSINESS ACCORDING TO SME DEVELOPMENT POLICY OF TANZANIA OF 2003

According to the Small and Medium Enterprise (SME) Development Policy of Tanzania (2003), a small business (or small enterprise) is defined based on the number of employees and capital investment. The classification is as follows:

Category No. of Employees	Capital Investment in Machinery (TZS)
Micro enterprise 1 – 4	Up to 5 million
Small enterprise 5 – 49	Above 5 million to 200 million
Medium enterprise 50 – 99	Above 200 million to 800 million
Large enterprise 100+	Above 800 million

Therefore, in context of this topic, the small business, means both micro and small enterprises.

CHARACTERISTICS OF A SMALL BUSINESS

1. Small number of employees

A small business typically has a limited number of workers, usually fewer than 50. This makes it easier to manage operations and maintain close contact with employees. For example, a tailoring shop with 10 employees.

2. Small capital investment

Small businesses require relatively little money to start and operate. Their machinery, tools, or stock are not as expensive as those of larger firms. For example, a local food vendor operating with a capital of TZS 3 million.

3. Owner-managed

In most small businesses, the owner plays an active role in daily operations and decision-making. This allows for direct supervision and personalized service. For example, a small retail shop where the owner manages sales and stock.

4. Localized market

Small businesses tend to serve customers in nearby or local areas rather than operating on a national or international scale. For instance, a bakery selling bread within the neighborhood.

5. Simple organizational structure

Due to their size, small businesses have a simple structure with few departments. This makes communication and coordination more efficient. For example, a printing shop where one person handles customer service and production.

6. Flexibility and quick decision-making

Small businesses can adapt quickly to changes because the decision-making process is not delayed by many layers of management. For instance, a small boutique adjusting clothing styles based on

customer feedback.

7. Limited access to finance

Small businesses often face challenges in obtaining loans or large investments from banks and financial institutions. This can limit their growth. For example, a carpenter struggling to get a loan to buy new tools.

IMPORTANCE OF SMALL BUSINESSES

Small businesses play a vital role in the economic and social development of a country. Their contributions go beyond just profits — they support communities, create jobs, and drive innovation.

1. Employment creation

Small businesses provide jobs to a large number of people, especially in developing countries. They help reduce unemployment and offer income to families. For example, a local carpentry workshop employing five young people.

2. Income generation

By offering self-employment and profits, small businesses help individuals earn a living and improve their standard of living. For example, a food vendor earns daily income to support her family.

3. Poverty reduction

Through job opportunities and income generation, small businesses contribute to reducing poverty in both rural and urban areas. For instance, women's craft groups selling handmade products to

support their homes.

4. Promotion of entrepreneurship

Small businesses encourage creativity, self-reliance, and the spirit of starting something new . They give people a chance to use their skills and talents. For example, a youth using digital skills to run a small online marketing business.

5. Contribute to economic Growth

They contribute to national income through taxes, local production, and services, helping the economy grow . For example, a small-scale maize mill that contributes to food processing and local trade.

6. Utilization of Local Resources

Small businesses often use locally available materials, which helps reduce imports and supports the local economy. For example, a brick-making business using local clay.

7. Development of Rural Areas

They bring goods, services, and jobs to areas that are often ignored by big businesses, helping balance national development. For instance, a motorcycle repair shop in a village

8. Supplier to large businesses

Most of small business supply raw materials to large businesses at low cost. This reduces production costs of large industries. For example, local cotton farmers supplying cotton to the textile industries.

2.2. SOURCES OF FINANCE FOR SMALL BUSINESS

There are different ways in which a small-sized business can finance its operation. Such sources include, loans, personal savings, deferred payments and funds from family and friends.

A. LOAN

A loan is a sum of money borrowed from a lender (bank, financial institution, or individual), with the agreement to repay it at an agreed time with interest. An interest refers to the monetary cost of borrowed money. It is usually expressed as a percentage rate of the borrowed funds.

ADVANTAGES OF LOANS FOR FINANCING SMALL BUSINESSES

1. Access to capital

Loans provide small businesses with the money they need to start or grow their businesses when internal funds are not enough. For example, a small grocery store borrows money to restock products

during high-demand seasons.

2. Business ownership is maintained

Unlike investors who may ask for shares or control, loans do not take away any ownership from the business owner. For instance, a tailor borrows money to expand but remains the sole owner of the business.

3. Fixed repayment schedule

Loans usually come with a clear repayment plan, making it easier for business owners to manage their finances and plan ahead. For example, a shop owner repays TZS 300,000 every month for one year.

4. Helps build credit history

Regular and timely repayment of loans builds a positive credit history, which can help the small businesses qualify for bigger loans in the future. For example, a farmer who repays a small loan successfully gets a larger loan the next season.

5. Supports business expansion

Loans can help small businesses increase their production, open new branches, or enter new markets. For example, a poultry farmer uses a loan to build more chicken houses and expand operations.

6. Flexibility of use

The business owner usually decides how to use the loan – whether for buying stock, paying salaries, or investing in equipment. For example, a mechanic uses a loan partly to buy tools and partly to improve the workshop.

7. Promotes economic growth and employment

Loans enable small businesses to grow , which leads to more job opportunities and contributes to national economic development. For example, a small textile factory borrows money, expands production, and hires more workers.

DISADVANTAGES OF LOANS FOR FINANCING SMALL BUSINESSES

1. Repayment pressure

Loans must be repaid within a fixed time, whether the business makes a profit or not. This can create financial pressure. For example, a small shop struggles to repay the loan during a slow sales season.

2. Interest costs

Loans come with interest, which increases the total amount the business must repay. This reduces profits. For example, a loan of TZS 5 million may require a total repayment of TZS 6 million.

3.Collateral requirement

Banks often ask for security (collateral) like land or buildings, which small businesses may not have. For instance, a young entrepreneur is denied a loan because they don't own property.

4. Risk of losing assets

If the business fails to repay the loan, the lender may seize the collateral. For example, a furniture maker loses his workshop because he couldn't repay the loan.

5. Limited loan amount

Small businesses often get smaller loans than they need due to lack of credit history or collateral. For instance, a business requests TZS 10 million but receives only TZS 4 million.

6. Strict qualification requirements

To get a loan, SMEs must meet several requirements such as a business plan, financial records, and bank statements, which can be challenging for informal businesses. For example, a street food vendor may be rejected because they lack formal registration and records.

7. Discourages risk-taking

Loan repayment obligations may make business owners afraid to take new or innovative risks. For example, a boutique owner avoids trying new designs for fear of losing customers and being unable to repay the loan.

B. PERSONAL SA VING

Personal saving refers to the money that an individual sets aside from their own income, rather than spending all of it.

It is often the first and most accessible form of financing for many small business owners. For example, a person who works as a doctor saves part of his/her salary every month and uses that money to open a small pharmacy.

ADVANTAGES OF USING PERSONAL SA VING

1. No interest to pay

Money from personal savings does not come with interest, unlike loans, making it cost-effective. For example, a tailor uses her own money to buy a sewing machine without worrying about extra costs.

2. Full ownership and control

The owner retains complete control over the business, as there are no external investors. For example, a farmer starts poultry keeping without sharing profits with anyone else.

3. No collateral needed

Since the money comes from the owner, there is no need to provide security or assets as collateral. For instance, a young graduate starts a mobile money business using her own saved funds.

4. Quick access to funds

Personal savings can be accessed easily without long processes or paperwork. For example, a vendor uses her savings to restock her kiosk immediately after selling out the stocks.

5. Encourages financial discipline

Saving money for business teaches discipline and proper money management. For example, a student learns to cut unnecessary expenses in order to grow future business capital.

6. Less financial risk

There is no pressure from lenders or investors, reducing the stress of repayment or meeting investor expectations. For example, a shoe maker experiments with new designs using her own capital without

fear of losing someone else’s money.

7. **Supports long-term planning**

Personal savings are usually set aside with a goal in mind, making them useful for planned andpurposeful business decisions. For example, a carpenter saves for 6 months to open a small furniture

workshop.

DISADVANTAGES OF USING PERSONAL SA VING

1. **Limited capital**

Personal savings may not be enough to meet all business needs, especially for larger investments. For example, a person wants to start a car repair garage but only has enough savings to buy a few tools.

2. **Slow business growth**

Since the capital is limited, it may take longer for the business to grow or expand. For example, a clothes vendor cannot afford to open a second shop due to low savings.

3. **High personal financial risk**

If the business fails, the owner may lose all their personal savings, affecting their financial security . For example, a woman uses her life savings to start a salon, but the business does not succeed.

4. **No financial backup (emergency fund**)

Using all personal savings can leave the owner without emergency funds for personal or family needs.

For example, a man spends all his savings on a business, but has no money left when his child falls sick.

5. **May delay business start-up**

It takes time to save enough money, which can delay the launch of the business. For example, a youth who wants to start a printing business has to wait two years to save enough capital.

6. **Lack of financial advice or support**

When using personal savings, the owner might not get professional guidance that comes with funding from financial institutions or investors. For instance, a first-time entrepreneur uses savings but lacks

a mentor or advisor to guide business planning.

7. Discourages seeking other opportunities

Over-reliance on personal savings might prevent the business owner from exploring better funding options that could boost the business faster. For example, a baker refuses to apply for a grant or loan, even though it could help buy a bigger oven.

8. Behavioural biases

Some business individuals may struggle with spending habits that my either hinder them form saving, or depleting the saved money on impulse purchases. For example, a Food vendor may use her business savings to pay for friend's wedding contributions, instead of expanding her business.

C. FUNDS FROM FAMILY AND FRIENDS

Funds from family and friends refer to the financial support that a small business owner receives from close relatives or trusted friends. This support can come in the form of a loan, a gift, or even a partnership investment to help start or grow the business. It is usually based on trust and personal relationships, and it often comes with little or no interest.

ADVANTAGES OF FUNDS FROM FAMILY AND FRIENDS

1. Easier access to capital

Getting funds from family and friends is usually quicker and less complicated than applying for bank loans. For example, a young entrepreneur borrows TZS 500,000 from her uncle to buy raw materials

for her homemade soap business.

2. Flexible repayment terms

Family and friends often allow more flexible or informal repayment schedules. For example, a friend lends money to a small business owner and agrees to be repaid after six months, once the business

starts making profit.

3. Low or no interest

Unlike banks, family and friends may offer loans without charging any interest. For instance, a brother supports his sister's poultry business by giving her TZS 300,000 as an interest-free loan.

4. Trust-based support

Since there is trust and personal relationship, the borrower may not need to provide collateral. For example, a father gives his son capital to start a mobile money kiosk, trusting his son's honesty and commitment.

5. Boosts confidence and encouragement

Support from loved ones motivates the entrepreneur and builds self - belief. For example, a cousin invests in a friend's tailoring business and also encourages them to market their services on social media.

6. Faster business start-up

Immediate access to funds helps the entrepreneur launch the business faster. For example, a young graduate receives startup funds from her aunt and is able to open a food vending business

right after school.

7. No formal requirements

Funds from family and friends usually don' t require formal procedures like credit checks or business plans. For example, a mother gives her daughter money to start selling secondhand clothes without asking for any written agreement.

8. Shared risk in case of joint venture

Sometimes family or friends become business partners, sharing in both risks and profits. For example, two friends contribute money equally to start a small retail shop and run it together.

DISADVANTAGES OF FUNDS FROM FAMILY AND FRIENDS

1. Risk of damaging relationships

If the business fails or the money is not repaid on time, it can lead to conflict or loss of trust. For example, a man borrows money from his sister to open a shop, but when the shop fails, they stop speaking to each other.

2. Limited amount of capital

Family and friends may not have enough money to fully support the business needs. For example , a woman wants TZS 3 million to open a small restaurant but can only raise TZS 1 million from

relatives.

3. Lack of formal agreements

Many times, these funds are given without written agreements, which can cause confusion or disagreements later. For example, a friend gives money expecting to be a partner, but the business owner considers it a loan.

4. Creates dependency

Relying too much on family and friends may stop the entrepreneur from seeking independent solutions or learning how to secure formal funding. For example, a youth keeps asking for money from relatives instead of learning to apply for small business grants.

5. No business guidance or mentorship

Family and friends may not have business knowledge, so while they offer money, they may not provide useful advice. For example, a cousin funds a boutique but cannot help with marketing or pricing strategies.

6. Not a long-term funding solution

This source is usually one-time or short-term, and may not be reliable for business growth or future expansion. For example, after starting the business with help from friends, the owner struggles to raise funds for expansion later.

D. DEFERRED PA YMENT

Deferred payment is a payment arrangement where a buyer receives goods or services immediately but agrees to pay for them at a later date, either in one lump sum or through installments.

For example, a shopkeeper buys 100 bags of cement from a supplier in March and agrees to pay the full amount after 60 days. The supplier delivers the cement immediately , and the shopkeeper starts selling it. He uses the money earned from selling the cement to pay the supplier in May.

ADVANTAGES OF DEFERRED PA YMENT

TO THE BUYER:

1. Improved cash flow

The buyer can use the product or service immediately without paying upfront, allowing them to use available cash for other needs. For example, a small business gets inventory on credit and uses sales

revenue to pay later.

2. Business continuity

Deferred payment helps businesses operate smoothly even when they face temporary cash shortages. For instance, a retailer continues operating during a slow sales season by deferring payments to suppliers.

3. **Convenient for budgeting**

Buyers can plan their finances and make payments over time. For example, a farmer buys fertilizers and agrees to pay after harvest, when cash is available.

4. **Access to better equipment or goods**

Buyers can afford higher-quality goods or larger quantities through credit. For example, a shopkeeper acquires a large freezer through deferred payment.

5. **Opportunity to generate revenue before paying**

Buyers can sell products and earn revenue before settling the payment. For example, a boutique sells clothes bought on credit before the due payment date.

TO THE SELLER:

1. **Increased sales volume**

Offering deferred payment attracts more customers, increasing sales. For example, a supplier sells more items to small shops by offering 30-day payment terms.

2. **Competitive advantage**

Sellers gain an edge over competitors who don’t offer credit terms. For example, a furniture seller attracts more customers by allowing payment in three installments.

3. **Stronger customer relationships**

Building trust by offering deferred payment can lead to long-term business relationships. For example, a distributor offers credit to regular customers, encouraging loyalty.

4. **Potential to charge interest or fees**

Sellers may include interest or service charges, increasing their revenue. For example, a seller adds a 5% fee on goods sold under a deferred payment agreement.

5. **Faster movement of inventory**

Credit sales can help clear stock quickly. For example, a wholesaler sells more goods to retailers when payments are deferred.

DISADVANTAGES OF DEFERRED PA YMENT

TO THE BUYER:

1. Debt accumulation

Relying too much on deferred payments can lead to piling debts that are hard to manage. For example, a small shopkeeper buys goods on credit from multiple suppliers and later struggles to repay all of them at once.

2. Interest or penalties

Some sellers add interest or late payment penalties, increasing the total cost of the item. For example, a buyer who delays payment on a deferred agreement pays an additional 10% penalty.

3. Loss of discounts

Cash buyers often receive discounts, which deferred payment buyers may miss. For example, a retailer who pays immediately gets a 5% discount, while the credit buyer pays the full price.

4. Risk of legal action

Failure to meet payment deadlines may lead to legal action or bad credit records. For instance, a business that defaults on a deferred payment contract may be sued by the supplier.

5. Overdependence on credit

Relying on credit may discourage financial discipline and saving. For example, a small business continually buys goods on credit and struggles with cash flow due to constant repayments.

TO THE SELLER:

1. Delayed cash inflow

The seller does not receive payment immediately , which may affect their own operations. For example, a supplier waits 60 days to receive payment, while needing cash to restock.

2. Risk of default

Some buyers may fail to pay, leading to financial loss. For instance, a seller supplies goods on credit to a customer who later disappears or refuses to pay.

3. Increased administrative work

Managing deferred payment accounts requires extra record-keeping and follow-up. A business must hire staff to track credit accounts and remind customers of due dates.

4. **Bad Debts**

If buyers don't pay, the seller may write off the amount as a bad debt. A seller loses TZS 300,000 after a customer fails to repay a deferred amount.

5. **Limited capital for reinvestment**

Tied-up funds reduce the ability to invest in new stock or expand the business. For example, a seller cannot buy new products because too much money is tied in unpaid invoices.

2.3. MICROFINANCE AND COOPERATIVES

MICROFINANCING

Microfinancing refers to the provision of small loans, savings, and other financial services to individuals or small businesses who do not have access to traditional banking services. These services are typically targeted at low-income people or those living in poverty, often in developing countries.

Microfinancing is usually offered by microfinance institutions (MFIs), and the loans are typically small, with relatively low or no interest rates. Additionally, these loans often come with flexible repayment terms.

Examples of the most common microfinance institutions in Tanzania, include the following:

— PRIDE Tanzania

— FINCA Microfinance Bank (T) Limited

VisionFund Tanzania Microfinance Bank

— Enabel (through local programs)

— Selfina (Sero Lease and Finance Ltd) Tujijenge Tanzania

— ECLOF Tanzania

— AccessBank Tanzania

— Bayport Financial Services

— Maendeleo Bank

— Yetu Microfinance Bank PLC

— Umoja Microfinance

— Village Community Banks (VICOBA)

— BRAC Tanzania Finance Limited

— Wazalendo Savings and Credit Cooperative Society (SACCOS)

— National Microfinance Bank (NMB) – through micro-loan products

ADVANTAGES OF MICROFINANCING:

1. Financial Inclusion

Microfinancing provides access to financial services for individuals who are typically excluded from traditional banking systems, such as low-income earners, rural populations, and women.

2. Empowerment of women

Microfinance programs often target women, helping them become financially independent, start businesses, and improve their families' living standards.

3. Promotion of entrepreneurship

By providing small loans, microfinancing encourages entrepreneurship, allowing individuals to start or grow their own businesses. For example, a young entrepreneur starts a small shop selling groceries with a microloan, leading to a sustainable source of income.

4. Poverty reduction

Microfinancing helps to break the cycle of poverty by providing low-income individuals with the financial resources needed to improve their livelihoods. For example, a small business owner can use a microloan to buy more inventory, increasing their income and improving their living conditions.

5. Job creation

Microfinance fosters the growth of small businesses, which in turn can create jobs for others, helping to reduce unemployment in low-income areas. For example, a small tailoring business that received a microloan hires additional workers to meet the demand for its services.

6. Flexible loan terms

Microfinance institutions often provide flexible repayment schedules and smaller loan amounts, making it easier for borrowers to manage their payments based on their income or business cycle.

7. **Improved access to education and healthcare**

With increased income from microloans, individuals may be able to afford education for their children or access healthcare services that would otherwise be out of reach. For example, a woman running a small business uses part of her earnings to pay for her children's school fees, improving their future prospects.

8. **Promotion of local economies**

Microfinance stimulates local economies by supporting small businesses, which then contribute to local development and the overall economic growth of the region.

DISADVANTAGES OF MICROFINANCING

1. **High-Interest Rates**

Some microfinance institutions charge high-interest rates on loans, which can be difficult for borrowers to repay, especially if their businesses don't perform as expected.

2. Risk of over-indebtedness

Borrowers may take out multiple microloans from different institutions to meet their needs, leading to the risk of accumulating excessive debt that is difficult to manage.

3. Limited loan size

The small size of microloans may not be sufficient for borrowers looking to significantly grow or expand their businesses, especially in sectors that require large capital investments.

4. Pressure to repay

The pressure to repay loans, sometimes with rigid schedules, can strain borrowers who may face challenges in generating steady income, especially in the early stages of their businesses.

5. Lack of financial literacy

Some borrowers may not fully understand the terms and conditions of the loan, leading to poor financial decisions or defaults.

6. Dependency on microloans

Repeated reliance on microloans can create dependency, rather than encouraging the development of sustainable, self-sufficient businesses.

7. Limited support beyond loans

Microfinance institutions often provide loans but may not offer additional support, such as business training or financial counseling, leaving borrowers to manage the challenges of business growth on their own.

COOPERATIVES

Cooperatives are voluntary associations or organizations formed by individuals or businesses with common interests or goals. These organizations are typically owned and operated by their members, who share in the profits, decision-making, and risks. Cooperatives can operate in various sectors, including agriculture, retail, finance, housing, and healthcare.

Examples of cooperatives in Tanzania includes:

— Tanzania Farmers Association (TFA)

— Tanzania Coffee Growers Association (TCGA)

— Tanzania Dairy Cooperative Societies

— Tanzania Sugar Cane Growers Association (TASGA)

— Tanzania Co-operative Bank (TCB)

— Tanzania Cashew Nut Cooperative Union (TCNCU)

— Mbozi District Cooperative Union

— Sumbawanga Co-operative Union

— Kilimanjaro Co-operative Union (KCU)

— Mwanga District Cooperative Union

— Central Zone Coffee Cooperative Union (CEZCO)

— Mtwara Cashew Nut Cooperative Union (MCCU)

— Savings and Credit Cooperative Societies (SACCOS)

ADVANTAGES OF COOPERATIVES FOR SMALL BUSINESSES:

1. Access to credit and financial services

Cooperatives often provide loans or credit facilities to members, helping them finance their businesses. For example, a farmer can access a loan from a cooperative to buy seeds or tools.

2. Bulk purchasing power

Members of a cooperative can pool their resources to purchase goods in bulk, reducing costs and increasing their bargaining power. For example, a group of small shopkeepers buys wholesale goods through their cooperative to get better prices.

3. Risk sharing

By being part of a cooperative, members can share risks, reducing individual exposure to financial loss. For example, several farmers in a cooperative share the financial risk of crop failure, reducing the burden on any one individual.

4. Market access and networking

Cooperatives can help small businesses access larger markets through collective branding and distribution. For example, a group of local artisans sells their products collectively under the cooperative's brand, gaining access to wider markets.

5. Training and capacity building

Cooperatives often provide business training, skills development, and education to members, helping them improve their business practices.

6. Profit sharing

Members of a cooperative share in the profits based on their contribution, which provides a financial incentive to be part of the cooperative.

7. Legal and political support

Cooperatives often advocate for their members at local or national levels, providing legal and political support.

8. Enhanced social capital

Cooperatives promote a sense of community and social solidarity among members, helping them to build stronger relationships and collaborate effectively. s.

DISADVANTAGES OF COOPERATIVES FOR SMALL BUSINESSES

1. Limited access to capital

Cooperatives may face challenges in raising large amounts of capital, as they rely mostly on members' contributions.

2. Slow decision-making process

In cooperatives, decisions are often made collectively, which can lead to delays and inefficiencies. For example, a cooperative might take longer to decide on new business opportunities because of the need for consensus among all members.

3. Risk of Conflicts Among Members

Differing opinions, interests, and business practices among members can lead to conflicts, which can disrupt operations. For example, farmers in a cooperative might disagree on how to divide profits, causing tension within the group.

4. Limited Management Expertise

Cooperatives may lack professional management or experience in handling business operations, affecting their efficiency. For example, a cooperative may struggle to scale its business effectively due to a lack of experienced managers or strategic planning.

5. Unequal benefits

Members with more resources or expertise might benefit more than others, leading to inequality in the distribution of profits and resources.

6. Potential for Mismanagement

Cooperatives often depend on elected members for leadership, which can lead to mismanagement if those in charge lack experience. For example, poor decision-making by cooperative leaders can result in financial losses or a decline in the cooperative's performance.

7. Limited flexibility

Cooperatives are often more rigid due to their rules, regulations, and collective decision-making processes, which can limit business adaptability. For example, a cooperative may not be able to quickly adapt to market changes or opportunities because of its slow decision-making process.