Available online at www.sciencedirect.com

ScienceDirect

Review of Development Finance 7 (2017) 6–17

Review of DEVELOPMENT FINANCE

www.elsevier.com/locate/rdf

Full length article

Access to finance and firm performance: Evidence from African countries☆

Babajide Fowowe

Department of Economics, University of Ibadan, Nigeria

Abstract

This study conducts an empirical investigation of the effects of access to finance on the growth of firms in African countries. In order to achieve this, we made use of a new rich enterprise-level data set from the World Bank's Enterprise Surveys and employ both subjective and objective measures of access to finance. The subjective measure of access to finance is obtained from the ranking of access to finance as no obstacle or severe obstacle to business operations. The objective measure of access to finance is a variable which measures whether firms are constrained in obtaining credit or not. We use data for 10,888 firms across 30 African countries and the results using the subjective measure show that the access to finance constraint exerts a significant negative effect on firm growth. Also, the results using the objective measure show that firms that are not credit constrained experience faster growth than firms which are credit constrained. These results lend credence to the view that financing is very important for firm growth, and justifies the many measures and initiatives being put in place to make more finance available for African firms.

JEL classification: G10; G20; L25; O16

Keywords: Access to finance; Firm growth; Financial constraints; Africa

1. Introduction

The importance of finance to the growth of firms has been well documented in the literature and the firm-financing gap has become common terminology, depicting the inadequate access to finance faced particularly by firms (OECD, 2006a,b; Deakins et al., 2008; IFC, 2010). Insufficient finance is a key obstacle to firm growth (Malhotra et al., 2007) and it has been found that small firms face bigger challenges in obtaining finance as compared to larger firms (Schiffer and Weder, 2001; Beck et al., 2002). Financing is important for firms because it helps in expansion of operations, innovation, and investing in production facilities and new staff (OECD, 2006b). There has been increased attention focused on the role of firms in affecting economic growth, employment creation, and poverty reduction. Firms have been identified as important avenues for employment and job creation in both developing and developed countries.

However, many firms that are willing to expand often find it difficult to obtain financing from financial institutions and are thus credit constrained. This essentially constitutes the 'financing-gap' faced by firms and this gap is more prevalent in developing countries while it is not such a problem in advanced economies because various risk-coping strategies have been adopted by banks for lending to firms (OECD, 2006b). Thus, the financing-gap is essentially a problem for developing countries. It is well known that out of the group of developing countries, African countries are severely disadvantaged in financial development (Allen et al., 2011; Beck et al., 2009; Fowowe and Abidoye, 2013; Fowowe, 2013). Thus, the firm-financing gap is likely going to be a bigger problem for African countries than for countries in other developing regions.

This has indeed been observed from available survey data as access to finance has consistently ranked as one of the top constraints cited by firms. In Gelb et al.'s (2007) study of 26 African countries, it is seen that on average, the percentage of firms citing access to finance as a major or severe constraint was higher than for any other constraint (electricity, corruption, macro-economic instability, and labour regulations). Also, in the study by Dinh et al. (2012) which used a sample of over 39,000 firms across 98 countries, it was found that access to finance was

☆ I acknowledge financial support from the African Economic Research Consortium, Grant No. RC13538. I also thank anonymous referees for useful comments.

E-mail address: babafowowe@hotmail.com

Peer review under responsibility of Africagrowth Institute.

Production and hosting by Elsevier

1879-9337
http://dx.doi.org/10.1016/j.rdf.2017.01.006

ranked as either the biggest or second biggest obstacle by firms in Eastern Europe and Central Asia, Sub-Saharan Africa, East Asia and Pacific, Middle East and North Africa, and South Asia. It was only in Latin America and the Caribbean that access to finance was ranked as the third biggest obstacle. Looking closely at the 38 Sub-Saharan African countries in Dinh et al.'s (2012) study, it is seen that electricity was the top ranked constraint in 16 countries while access to finance was the top ranked constraint in 11 countries.

This study conducts an empirical investigation of the effects of access to finance on the growth of firms in African countries. In order to achieve this, we make use of a new rich enterprise-level data set from the World Bank's Enterprise Surveys and employ both subjective and objective measures of access to finance. This ensures the robustness of the results and thus the results are not influenced by idiosyncratic differences of respondents as may be reflected in subjective data.

This study will add to the existing literature in 3 main ways. Firstly, our exclusive focus on firm-level data for African countries offers new insights into understanding the behaviour and performance of African firms, and this would assist in developing new and innovative ways for achieving firm growth which is important in alleviating poverty. Secondly, we deviate from many existing studies by constructing objective measures of firms' access to finance following the method described in Kuntchev et al. (2013) and this offers a more comprehensive understanding of how finance affects the performance of firms. Thirdly, this study addresses the 'twin' issues of finance that firms face – access to finance constraints and participation in financial markets – and thus offers a broad analysis and discussion of finance for firms in Africa.

2. Literature review

One of the central tenets of the vast literature on the finance-growth nexus is that finance promotes growth by channelling credit to the most eligible firms and there is a lot of macroeconomic evidence which shows that financial development enhances overall growth of the economy (Levine, 2005). There have also emerged an increasing number of microeconomic studies which have shown that finance exerts a positive effect on the growth of firms (Demirguc-Kunt and Maksimovic, 1998).

We can identify 3 broad group of studies that have examined the effects of access to finance on growth of firms across the world. The first group of studies are early studies that combined firm-level data with broad macroeconomic indicators of financial development for a cross-section of countries to examine the relationship between a more developed financial sector and firm performance. Such studies include Demirguc-Kunt and Maksimovic (1998), Beck et al. (2008, 2006), and Demirguc-Kunt et al. (2006). The second group of studies are country-specific studies which also combined firm data with financial development. Such studies include Butler and Cornaggia (2007) and Girma et al. (2008). The broad consensus from these studies is that better developed financial systems foster the growth of firms. The third group of studies make use of recent firm-level data, especially from the World Bank, which relies on responses from firms on various constraints to doing business and on their accessibility to financial markets. This has given rise to new studies which make use of strictly firm level data to examine how access to finance and other constraints affect firm performance. Such studies include Beck et al. (2005), Ayyagari et al. (2008), Dinh et al. (2012), Aterido and Hallward-Driemeier (2010), and Aterido et al. (2011).

This last group of studies forms the central focus of this study. Existing studies into the effects of financing constraints and access to finance on the performance of firms have largely made use of data across a broad spectrum of developed and developing countries. This study focuses exclusively on African countries which have been shown to be generally less financially developed than countries in other regions. The study will therefore enhance in understanding how improved and better functioning financial markets will enhance the growth of African firms.

3. Data

3.1. Enterprise Surveys dataset

This study uses data from the Enterprise Surveys which are a newly available firm-level data set provided by the World Bank and its partners across the world. The surveys cover more than 130,000 firms in 125 countries during the period 2006–2012. The Enterprise Surveys focus on the many factors that shape the business environment and these factors can be accommodating or constraining for firms and play an important role in whether a country will prosper or not (World Bank, 2012). The surveys are administered to a representative sample of firms in the non-agricultural formal private economy and makes use of a uniform universe, uniform methodology of implementation, and a core questionnaire which makes the surveys comparable across countries and survey years.

The core questionnaire, which contains survey questions answered by business owners and top managers around the world, provides both subjective and objective information on the business environment that firms confront. The subjective evaluations show the severity of obstacles that firms face and the questionnaire asks firms to rank 16 components of the business environment, indicating which represent the biggest obstacles, and to evaluate these 16 components on a scale of 1–5 (1 being no obstacle and 5 being a severe obstacle). This makes it possible to identify the top obstacles and examine the obstacles firms consider the most important. The Enterprise Surveys are also very good because they provide a set of objective measures of the business environment, such as if firms have an overdraft facility or how many times do power outages occur. These objective measures become very useful particularly when we want to overcome the potential shortcomings of subjective measures. Aterido et al. (2011) note that drawbacks of subjective measures include the fact that firms' perceptions of the business environment reflect idiosyncratic differences in the degree of optimism or pessimism of the individuals responding to the survey. Also, subjective measures are deficient because answers are likely to be strongly influenced by the experience and performance of the firm.