

**Interest Rate And Profitability Of Small And Medium Enterprises In Kaharo Sub-County, Kabale District,
Uganda**

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Abstract

Small and medium sized enterprises (SMEs) play a crucial role in economic development, both in developing and developed countries. The study examined a wide analytical view on the question of interest rate charged by commercial institutions on profitability and growth of SMEs in Uganda a case study of selected SMEs in Kaharo sub-county Kabale District. The purpose of the study was to assess the effect of interest rate charged by commercial institutions on profitability and growth of SMEs in Kaharo sub-county Kabale District, Uganda. The specific objectives of this study were to: identify the determinants of Profitability in SMEs in Kaharo sub-county Kabale District, Uganda, find out the challenges affecting SMEs in Kaharo sub-county Kabale District, Uganda; and examine the effect of interest rates on growth of SMEs in Kaharo sub-county Kabale District, Uganda. The design used for this study was descriptive method. Descriptive research is a collection and interpretation of data. Both quantitative and qualitative approaches were used to gather information by asking a greater number of people from the sample chosen with known backgrounds and this helped the researcher to get possible, broad and accurate view of responses. A total of fifty (50) respondents were selected for the study. Simple random sampling was used to select the twenty (20) clients of selected small scale and medium sized enterprises while purposive sampling was also used to select thirty (30) traders of selected small scale and medium sized enterprises. From the study findings on determinants of Profitability in SMEs in Kaharo sub-county Kabale District, the highest number of the respondents mentioned business location and the least number of respondents mentioned types of commodities sold. The study findings on challenges affecting SMEs in Kaharo sub-county Kabale District, the highest number of respondents mentioned access to finance while the least number of respondents mentioned limited capital among SMEs. The study findings on the effects of interest rates on growth of SMEs in Kaharo sub-county Kabale District, the highest number of respondents mentioned that it enables small scale businesses to provide sustainable financial services and the least number of respondents mentioned help to improve businesses. The study recommended that The small scale businesses should be encouraged to make savings as their habit so that they can reduce their dependent on the financial institutions for access to finance. The government should reduce on the taxes that are imposed on SMEs so that they can be able to grow and maximize their sales. Small scale and medium sized enterprises should be able to learn all conditions and be competitive so that they can survive competition from big businesses. The government should intervene by providing the necessary better political climate so that SMEs can be able to work and expand their businesses.

**Keywords: Profitability, interest rate, small and medium sized enterprises, economic development,
competition.**

Introduction

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The primary task for any business regardless of its size, capital, ownership and nature is to earn profit. Several factors which have been found to be the main determinants of SMEs profitability which include credit financing, SME industry, age of SMEs and legal composition of the SMEs. SMEs financing plays a crucial role on firm's profitability and lack of credit financing limits firms activities (Turyatamba et al., 2022). Although it is difficult to construct the measures for firm performance in the SSE sector, many studies have attempted to do this and found that greater sales and profits are associated with greater access to credit financing (Kazaara & Christopher, 2023). In addition, firms with increasing sales and increasing sales turnover ratios would be expected to have less credit constraints (N. Faridah et al., 2023). Guffey (2008) recognizes the importance of financing on SMEs arguing that unless SMEs owners can count on the finance banking of their relatives, they will need finances such sources like bank loans or venture capital. There are various ways the business owners can finance the growth of their firms but the fundamental decision is whether or not to accept external equity finance return for part ownership of the business. If owners allow external equity finance, they choose to relinquish part of their control to either a financial institution or other individuals (Paul et al., 2023).

SMEs perceive access to credit financing as a major stumbling block to the profitability of their operations. Credit financing constraints are particularly severe in start-up enterprises and relatively young firms (three years old or less) smaller firms have lesser assets to offer as collateral. In order to reduce the anticipated risk and moral hazard associated with lending, the

banks use collateral as one of the instruments (Richard et al., 2023). The collateral is an assurance to the bank in case of default and it also ensures the borrowers commitment to the loan repayments. In addition, smaller and younger firms are more likely to face higher cost of financing and they are required to offer collateral (Kazaara & Christopher, 2023).

Industry factors significantly determine SMEs profitability whereby a number of studies carried out to identify the influence of a firms industry on the profitability of the firm concur that there are significant differences between sectors in terms of the typical profitability of the firms. Only a few studies show sector variables not to be significant (Annet et al., 2023). Some industries are known to have higher firms' profitability than others mostly depending on capital required to be invested in assets and the level of sales. The degree of concentration in an industry also determines firm profitability (Polycarp et al., 2023). A higher concentration enables collusion between firms which can lead to higher profits. Industry effect models argue that differences in industry-level characteristics, such as efficiency level, industry structure or quality of top management firms and specific industry regulations cause differences in profitability (Faith et al., 2023). In addition, sectors that require more capital investment in equipment, machinery, buildings, labour and raw materials have fewer finances hence are less profitable.

The age of SMEs is an important factor influencing the profitability of the firm (Wegulo et al., 2023). Age of a firm helps in determining the competitive advantage of the firm over other firm and it also help the firm to design its competitive strategies. Age of the firm also

leads to the creation of firm image in the eyes of customer which leads to increased sales for the firm and firm increased profit. An SMEs that has been in existence for long also has a large market share which plays a key role in identification of firm profitability and its position in the industry and is also able to identify the level of competition and the way to form all lever of strategies (corporate level, business level and product level) to counter that competition (Alex & Kazaara, 2023).

Theoretically, a firm constituted such that the owner/managers enjoy limited liability has been said to have a greater incentive to pursue risky projects and therefore expects higher profits than other firms (Stiglitz and Weiss, 2011). Further, firms with limited liability and owned by more than one person are usually well structured, professionally managed and operated and therefore have high, stable and consistent profitability growth. (Winny et al., 2023) found that the positive effect of partnership on profitability was twice as large as that of the sole trader, taking limited liability and subsidiaries as the base case; this was explained by interpret the effects as risk tolerance and division between many individuals. Reduction in the volume of lending heavily impacts SMEs as these justifiable grounds supports that: rise in interest rate increases the costs of borrowing, this situation tend to discourages people from borrowing and saving. People who already have loans will have less disposable income because they spend more on interest payments, thus other areas of consumption tend to fall (Oromo et al., 2023). Rising interest rates affect both consumers and firms, as the economy is likely to experience falls in consumption and

investment as it tend to discourages investment as it makes firms and consumers less willing to take out risky investments and purchases. It reduces however, confidence in the sense that, interest rates have an effect on consumer and business confidence. In this ground it increases incentive to save rather than spend as the higher interest rates make it more attractive to save in a deposit account because of the interest gained (Nelson, Christopher, Teddy, et al., 2022).

Access to finance is seen as necessary condition for SMEs success in their drive to build productive capacity, to compete and to contribute to poverty alleviation in developing countries. Without finance, SMEs can neither absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms (Frank et al., 2023). Credit financing improves firm performance mostly in the first few years after start-up and financial leverage has a positive effect on the firm's return on equity provided that the earning powers of the firm's assets exceeds the average interest cost of debt to the firm (Franck and Huyghebaert, 2009).

Since SMEs typically rely on credit more than large firms, tightening of credit policies is expected to adversely affect SMEs more than larger firms which have access to national and even international credit markets (Gracious, 2023). Udell (2017) describes SMEs as 'informational opaque' when compared to large firms which are deemed to be 'informational transparent'. SMEs are considered informational opaque because often being relatively young firms, they lack an extensive history from which future firm or management performance can be extrapolated, even

though the firm may have high growth potential. For this reason, such firms have virtually low access to external funds from national markets such as through the issuance of commercial paper or publicly traded equity (Ntirandekura et al., 2022). In addition, most finance lending institutions provide asset backed financing. Therefore, for a small informational opaque firm with few tangible assets, unsecured loans may be the only source of external credit.

Firms that are informational opaque or have a low credit standing require close monitoring by a financial intermediary hence may not have direct access to the

credit markets (Karlan & Morduch, 2009). On the other hand, large, highly rated firms can directly access public credit markets by issuing instruments such as commercial papers (Alex et al., 2023). SMEs access to credit finance is constrained by in-availability of information on their credit worthiness. Public and private credit registries exist to improve the information available on borrowing in an effort to ease financing constraints (OECD, 2012). Advancing credit can be vitiated by adverse selection, explaining part of the difficulties encountered by SMEs in access to credit

Statement of the Problem

Small and medium sized enterprises (SMEs) play a crucial role in economic development, both in developing and developed countries. The contribution of SMEs to the economy can be seen through the value added every year generated by SMEs; SMEs employment, export participation, poverty alleviation, women empowerment (K. Faridah et al., 2023). It is believed that in developed and developing economies SMEs contribute on average 60% of formal employment Oguta et al., (2014). However, the ability of SMEs to grow depends highly on their potential to invest in restructuring and innovation (Frank et al., 2023). The rate of SMEs failure in Uganda is alarming. 33% to 41% of new SMEs fail within the first five years of their business operation including those in Kaharo sub-county Kabale District due to lack of finances (Christopher, 2022). Three out of five SMEs fail within their first three years of operation (Brighton et al., 2023). It is therefore widely recognized that 'bank lending gap' exists in the provision of modest amounts of finance to SMEs since all investments need capital. SMEs continue to face constraints caused by many common factors including commercial bank's lending policies of charging high interest rates. In line with this argument, bank lending has influence on profitability and growth of SME (Sabana, 2014). In contrary, (Ntirandekura et al., 2022) found out that bank lending to the SMEs sector had insignificant impact on their profitability and growth (Annet et al., 2023). Such contradictory and inconclusive evidence by different scholars attempted the researcher to go to the field to assess the effect of interest rate charged by commercial institutions on profitability and growth of SMEs in Uganda a case study of selected SMEs in Kaharo sub-county Kabale District (Annet et al., 2023).

General Objective of the Study

The purpose of the study was to assess the effect of interest rate charged by commercial institutions on profitability and growth of SMEs in Kaharo sub-county Kabale District, Uganda.

Specific Objectives of the Study

1. To identify the determinants of Profitability in SMEs in Kaharo sub-county Kabale District, Uganda.

2. To find out the challenges affecting SMEs in Kaharo sub-county Kabale District, Uganda.
3. To examine the effect of interest rates on growth of SMEs in Kaharo sub-county Kabale District, Uganda.

Methodology

The design used for this study was descriptive method. Descriptive research is a collection and interpretation of data. Both quantitative and qualitative approaches were used to gather information by asking a greater number of people from the sample chosen with known backgrounds and this helped the researcher to get possible, broad and accurate view of responses to certain issues and then test theories on social relationships and this enabled the researcher in drawing valid and dependable conclusion and recommendation of the study. The study was carried out in Kaharo sub-county Kabale district. It considered a total population of 60 traders from selected small scale and medium sized enterprises in Kaharo sub-county Kabale district. A sample size of 50 traders from the selected small-scale enterprises in Kaharo sub-county Kabale district was used and a sample was got by using the following Raosoft simple formula. Data was analyzed in form of tables, frequencies and percentages using SPSS & STATA (Nelson, Christopher, & Milton, 2022)

Results

Table 1: Determinants of Profitability in SMEs in Kaharo sub-county Kabale District

Determinants of Profitability in SMEs in Kaharo sub-county Kabale District	Frequency	Percentages
Credit financing	06	12
Age of the business	07	14
Amount of sales	10	20
Business location	12	24
Types of commodities sold	04	8
Customer care services available	11	22
Total	50	100

Source: Primary Data 2023

From the study findings on the determinants of Profitability in SMEs in Kaharo sub-county Kabale District, 24% the highest number of the respondents mentioned business location and 8% of the respondents' mentioned types of commodities sold, 12% of respondents mentioned credit financing, 14% mentioned age of the business, 20% mentioned amount of sales and 22% mentioned customer care services available. The highest number of respondents mentioned business location because when the business is strategically located it gets more customers which in return leads to increased sales hence high profitability of the business (Isaac et al., 2023).

The researcher also attempted and sought for the concerns of research question two with the aim of documenting challenges affecting SMEs in Kaharo sub-county Kabale District and the results presented below in Table 2 were recorded.

Table 2: Challenges affecting SMEs in Kaharo sub-county Kabale District

Challenges affecting SMEs in Kaharo sub-county	Frequency	Percentages
Competition	06	12
Access to finance	16	32
High taxes imposed on SMEs	10	20
Political climate	13	26
Limited capital	05	10
Total	50	100

Source: Primary Data 2023

The study findings on challenges affecting SMEs in Kaharo sub-county Kabale District, 32% the highest number of respondents mentioned access to finance while 10% the least number of respondents mentioned limited capital among SMEs. Other respondents with 26% mentioned political climate, 20% of the respondents mentioned high taxes imposed on SMEs and 12% of the respondent's mentioned competition. The highest percent of respondents mentioned access to finance because SMEs have difficulties in accessing bank loans as a consequence to the high risk for ailing loans and lack of collateral required by banks which affects the development of SMEs (Lydia et al., 2023).

The researcher also attempted and sought for the concerns of research question three with the aim of documenting effects of interest rates on growth of SMEs in Kaharo sub-county Kabale District and the results presented below in table 6 were recorded.

Table 3: Respondent's opinions on effects of interest rates on growth of SMEs in Kaharo sub-county Kabale District

Effects of interest rates on growth of SMEs	Frequency	Percentages
Enables small scale businesses to provide sustainable financial services	15	30
Improved operational efficiency	06	12
Interest on loans Motivate SMEs to pay in time	07	14
Interest on savings motivate SMEs to save	13	26
Help to improve businesses	04	8
Cover up their costs	05	10
Total	50	100

Source: Primary Data 2023

The study finding effects of interest rates on growth of SMEs in Kaharo sub-county Kabale District, 30% the highest number of respondents mentioned that it enables small scale businesses to provide sustainable financial services and 8% the least number of respondents mentioned help to improve businesses, other respondents with 12% mentioned

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improved operational efficiency, 14% mentioned interest on loans Motivate SMEs to pay in time, 26% mentioned interest on savings motivate SMEs to save and 10% of the respondents mentioned cover up their costs. The highest number of respondents mentioned that it enables small scale businesses to provide sustainable financial services and this leads to business growth (Victoria et al., 2023).

Discussion

SMEs growth and development has different indicators. The mostly preferred indicators are not limited to sales, increase of employment over a period of time, asset creation, market share, profits and output (Tanzania National SMEs Development Policy, (2010). Indicators such as level of production and market share vary widely depending on the industry and as a result it is very difficult to use them for comparisons, while profit is not relevant unless measured for a period of time. Davidsson (2016) holds the views that, both sales and employment remain very important indicators for measuring the growth and development of enterprises. Data on the number of employees is usually easier to collect as they are much more important. On the other hand sales may be affected by inflation and it is very important to use several indicators together to study the growth and development of enterprises.

Lack of capital or financial resources is a major barrier to SMEs and entrepreneurs who usually have to mobilize their own capital or their own resources to establish or expand their business (Harvie, 2010). In developing countries; it was argued that, SMEs have difficulties in accessing bank loans as a consequence to the high risk for ailing loans, high bank interest rates (even higher rates charged by Micro Finance Institutions – MFIs) low profitability and lack of collateral required by banks. For many SMEs; the general argument is that, access to finance and capital appear to be difficult, this comes, as a consequence of weak banking institutions, lack of capital market and inefficient legal framework regarding credit and collateral assessment. Financing of SMEs and access to finance plays a crucial role in the growth process and development of the enterprises. Hongmei (2013) holds the view that, funds are the premise and foundation for investment and business activities and how to raise them is significant for modern financial management. In recognition of this reality is evidenced in experience of China, where about 99% of the country's business is SMEs, which made great contributions to the country's economic development. By entering the competition, the company tries to find competitive advantages that greatly affect the success of the enterprise (Walley, 2007). SMEs are usually not very competitive in terms of market knowledge, innovation, prudent investment, business operations and good management, which are important factors in improving the quality. Countries compete with other countries as a result of globalization and increased trade; thus barriers and other restrictions generally favor these countries (Lind, 2009). Competition is increasing by international companies as a result of the Free Trade Agreements. A survey of SMEs in developing countries by World Bank reported that; competition represents a risk for survival for individual enterprises. Although competition represents high risk, it is the one who pushes enterprises towards higher productivity which actually results in their growth and development.

The importance of SMEs to the economy of a country indicates how important it is to have government policies that support SMEs, including regulations that enable them to operate efficiently and regulations that reduce their administrative costs (Harvie and Lee, 2005 cited by Harvie (2010)). Although there have been initiatives by governments to promote and support SMEs in order to enhance their development and reduce poverty, there is still a lack of genuine administrative procedures such as accessibility to assistance from the government agencies. The URT SMEs policy (2003) recognizes the need to support the development of SMEs by putting more emphasis on the following:

Reconsidering review of public policies and regulations that discriminate against or hinder the start-up, survival, formalization and growth of SMEs; Enhancing the growth of the sector by ensuring roles of every key actor is well identified and assigned to. Strategies that facilitate provision of financial and nonfinancial services to SMEs are developed. Public-private partnerships for SME development are institutionalized.

According to Hudon (2006), results indicate that management performance and skills are clearly associated with financial performance. Each of the four dimensions which includes leadership skills, technical skills, organizational and communication abilities provide poor results for SMEs performance. Tucker (2001), Armendariz and Morduch (2005) upholds Hudson (2006) and further argue that management is a major variable in promoting growth of SMEs. As Harvie, (2010) noted loan's interest rates charged by lenders commercial bank are not well-suited with the growth of the SMEs and that most of them charge high interest rates compared to larger firms which usually comply with higher disclosure requirements to a greater extent.

Generally, theories agreed that interest rates yielded by any investment taking into account the following parameters: the risk-free cost of capital, inflationary expectations, the level of risk in the investment and the costs of the transaction. Indeed, interest rates are thus made to keep inflation within a target range for the health of economic activities to safeguard economic momentum (Satta, 2003). In a surveyed study to SMEs on the focus requested to anticipate if the future rise in interest rates would adversely impact their business, 86% say that their business has no borrowing but has cash reserves, which is shielding their business from such a rise. In the case to consider issues on consumer demand to fall, observation was however, that, cash reserves offset any interest rate rise. Therefore, higher interest rates will mean the cost of loans will go up, which will have a knock-on effect on peoples disposable income (Harvie, 2010).

Conclusion

From the study findings on determinants of Profitability in SMEs in Kaharo sub-county Kabale District, the highest number of the respondents mentioned business location and the least number of respondents mentioned types of commodities sold.

The study findings on challenges affecting SMEs in Kaharo sub-county Kabale District, the highest number of respondents mentioned access to finance while the least number of respondents mentioned limited capital among SMEs.

The study findings on the effects of interest rates on growth of SMEs in Kaharo sub-county Kabale District, the highest number of respondents mentioned that it enables small scale businesses to provide sustainable financial services and the least number of respondents mentioned help to improve businesses.

Recommendations

The small-scale businesses should be encouraged to make savings as their habit so that they can reduce their dependent on the financial institutions for access to finance.

The government should reduce on the taxes that are imposed on SMEs so that they can be able to grow and maximize their sales.

Small scale and medium sized enterprises should be able to learn all conditions and be competitive so that they can survive competition from big businesses.

The government should intervene by providing the necessary better political climate so that SMEs can be able to work and expand their businesses.

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