Does debt really matter on the profitability of small firms? A perspective on small manufacturing firms in Bulawayo, Zimbabwe

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Small firms are the engines for economic development of several developed countries such as the US and Japan. Developing countries such as Zimbabwe have also identified the potential of small firms to turn economies with negative growth into vibrant ones. For this reason, several governments in developing countries offer funding to small firms either directly or by guaranteeing the payment of such loans as lack of funding is cited as one of the major challenges faced by small businesses. Due to limited resources by governments, not all small firms receive funding from the government, therefore, the other option would be to go for bank loans. The aim of this paper was to investigate the impact of debt on the profitability of small manufacturing firms in Zimbabwe. The results indicated that the use of debt has a negative impact on the profitability of small manufacturing firms. The study recommended the creation of tax incentives and more equity funding for small manufacturing firms

Key words: Debt, profitability, small manufacturing firms.

INTRODUCTION

Of recent, there has been an increase in the recognition of the role played by small firms in national economies. Their contribution to job creation and poverty alleviation has been recognized by several governments of developing countries to the extent that they now include them in their development plans. Among the support structures include offering funding to the small firms' sector, usually at concessionary rates. But whether the use of such debt improves the profitability, thereby enhancing sustainability, is not well known (Abor, 2005). Zimbabwe suffers from high unemployment with an official estimate of approximately 80% of the economically active population unemployed (Central Statistics Office of Zimbabwe, 2009). One of the best ways to address unemployment is to leverage the employment creation potential of small businesses and to promote small business development. Small firms are expected to be an important vehicle to address the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development in Zimbabwe. According to the Organisation for Economic Cooperation and Development (2006) small firms are now recognized worldwide to be a key source of dynamism, innovation and flexibility. SMEs are responsible for the most net job creation and they make an important contribution to productivity and economic growth.

The manufacturing sector is very important to the economy of Zimbabwe. However, it is being constrained by capacity under-utilisation, inadequate research and development, reduced agricultural output, price controls since 2001, shortage of foreign currency, fuel, coal and electricity. The metal fabrication sub-sector is affected by

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lower output from Zimbabwe Steel Company, garment production is affected by reduced cotton crop whilst the food industry is being affected by lower grain and dairy products as there is a reduction in commercial herds. Access to finance is one of the major constraints (Mandiwanzu, 2007).

The definition of a small manufacturing firm is based on the following quantitative factors; the numbers of employees, asset base and structure and the turnover levels or revenue (Ngwenya and Ndlovu, 2003: 12). A small manufacturing firm is described as a business employing not more than 50 workers with more than 4, having an asset base of less than 12 million Zimbabwean dollars and with a formal legal structure (Kapoor et al., 1997:4). For the purpose of the study, a small manufacturing firm refers to a business entity with a legal structure, employing workers between 4 and 50 and engaged in any of the following activities: food processing such as baking, oil processing and grain milling, metal fabrication, garment production, carpentry, beer brewing, pottery, brick-making and plastic production using recycled materials (Kapoor et al., 1997:6). The study does not include firms that are informal and employ less than 5 full-time employees. The asset base is not used as a criterion for determining size as it is difficult to attach a fixed value to assets since the value is constantly changing due to high inflation rates prevailing in Zimbabwe.

This paper investigates the effects of debt financing on the profitability of small manufacturing firms in Bulawayo, Zimbabwe. It is based on the theory of capital structure put forward by Franco Modigliani and Merton Miller in 1963. The purpose of the study was to determine if the use of debt (leverage) by small firms in Zimbabwe led to an increase in the returns generated by a firm with the intention of improving the value of the firms through capital structure. The profitability of the small firms, for this paper, is determined in terms of profitability2 ratios. The ratios that are used include return on assets (ROA) and return on equity (ROE) and they are expressed as percentages. Book value of assets was used in calculation of ROA. Capital structure of the small firms was determined by the use of debt ratios, thus, dividing total debt by the value of total assets of a firm.

THE THEORETICAL FRAMEWORK

According to Andree and Kallberg (2008) the genesis of modern capital structure theory lies in the work of Modigliani and Miller (1958) in their famous proposition I – often referred to as the “irrelevance theorem”. The theorem suggests that, as an implication of equilibrium in perfect capital markets, the choice of capital structure does not affect a firm’s market value. Modigliani and Miller (1958) based their irrelevance theorem on certain perfect market assumptions. These assumptions include no corporate taxes, no brokerage or flotation cost for securities, and symmetrical information which implies that investors and managers have the same information about a firm’s prospects and that individuals and firms can borrow at the same rates of interest. It is, therefore, the assets of a firm that determine the value of the firm and not the way by which these assets are financed.

The initial perfect market assumptions, on which the 1958 theory of Modigliani and Miller was based, were later reviewed in 1963 with the introduction of the tax benefits of debt. This is attributed to the fact that a perfect market does not exist in the real world. Since interest on debt is tax-deductible, thereby creating tax savings for the borrower, it becomes possible for firms to minimize their costs of capital and maximize shareholders’ wealth by using debt. The tax advantage of debt makes it cheaper than equity. The mix of cheap debt with relatively expensive equity reduces a firm’s cost of capital, which is the cut-off rate for investment acceptance decisions. This is known as the leverage effect of debt, and refers to the use of debt capital to minimize a firm’s cost of capital and maximize its profitability. The tax advantage of debt substantially reduces the cost of debt in a firm’s capital structure. With a corporate tax rate of 50%, tax deductibility of interest payments on debt can make the cost of debt as little as half that of equity. Therefore, debt contributes to the attainment of higher return on equity (Modigliani and Miller, 1963: 433 - 444).

Therefore, the Modigliani and Miller theory assumes that a firm’s value is maximized when it employs more of debt in its capital structure than equity. When debt is used in the capital structure, the average cost of capital is reduced and profitability enhanced (Modigliani and Miller, 1963: 434). Leverage is a financing strategy designed to increase the rate of return on owners’ investment by generating a greater return on borrowed funds than the cost of using the funds. Leverage would be positive if return on assets (ROA) is greater than the before-tax interest rate paid on debt. Negative leverage occurs when a firm generates a ROA that is less than the before-tax interest rate on debt (Damodaran, 1999: 103).

The major advantage of using debt is its low cost compared to the cost of equity. The actual cost of debt to the firm is the after-tax cost of debt, which is the market interest rate less the marginal tax rate proportion. The actual cost of debt would therefore be:

\[
K_d = \frac{I}{(1-t)}
\]

Where

- \(K_d\) = cost of debt
- \(I\) = interest rate payable (Market interest rate)
The use of debt therefore reduces the amount of tax to be paid by a firm and increases the return to shareholders whilst the use of equity does not enjoy such a benefit.

Besides the tax advantage, the cost of debt is generally low as compared to equity due to the lower risk associated with debt as debt holders has the first claim in the case of insolvency (Damodaran, 1999: 103). Debt also makes planning easy because interest cost on debt is usually fixed which allows efficient planning as the cost will be known. As long as the interest on debt is lower than the return that can be earned on the funds supplied by creditors, this excess return accrues to the owners of the firm as their benefit of using debt (Bernstein, 1993: 610). Though debt has its fair portion of benefits, it does not come without costs. The major costs associated with debt include bankruptcy, agency costs and loss of flexibility (Damodaran, 1999: 229 - 237).

**EMPIRICAL LITERATURE ON THE EFFECT OF DEBT USAGE ON FIRM PERFORMANCE**

Studies on the effect of debt on returns have generated mixed results ranging from those supporting a positive relationship hypothesis to those opposing it. Some of the studies did not come up with any effect on returns, that is, they found that capital structures did not portray any relationship with the returns of a firm. Empirical studies such as Ruland and Zhou (2005: 279) and Robb and Robinson (2009) agree with Miller and Modigliani (1963) that the gains from leverage are significant, and that the use of debt increases the market value of a firm. Financial leverage has a positive effect on the firm's return on equity provided that the earning powers of the firm's assets (the ratio of earnings before interest and taxes to total assets) exceeds the average interest cost of debt to the firm. Abor (2005) conducted a study on the effect of debt on firms in Ghana which indicated a significantly positive association between total debt and total assets and return on equity. The results therefore portrayed a positive leverage. According to Berkivitch and Israel (1996), a firm's debt level and its value is positively related especially when shareholders have absolute control over the business of the firm and it is negatively related when debt holders have the power to influence the course of the business. The impact of debt on value of firms therefore, depends on the balance of power within a firm. If shareholders have more power, a positive leverage will prevail and if debt holders have more power, a negative leverage would take place. The use of high levels of debt in the capital structure leads to an increase or decrease in the return on shareholders' capital/return on owners equity (ROE). ROE refers to the return/monetary gain by shareholders in return for the capital they would have offered to firms. Debt is always desirable if a firm achieves relatively high profits as it results in higher returns to shareholders (positive leverage). If a firm incurs a major drop in income, employing more debt in the capital structure will be detrimental as the firm won't be able to cover the cost of debt (negative leverage).

Other studies such as Negash (2001: 115) and Phillips and Sipahioğlu (2004: 33) conclude that the tax benefits of leverage are insignificant. Negash (2001: 118), for instance finds that the use of debt has been found to have a negative impact on the profitability of the firms quoted on the Johannesburg Stock Exchange. Negash (2001) further argues that, although the potential gains from leverage over an infinite period of time are significant and comparable to what is reported in studies from developed countries, in line with the theory of Modigliani and Miller of 1963. The actual gains, however, are not as implied by the 1963 theory since the effective tax rate for most firms in South Africa is lower than the statutory rate. This is because non-debt tax minimization efforts such as depreciation and amortization (investment and not debt related tax shields) reduce the significance of interest deductions and the tax advantages of debt.

Empirical studies on the static theory discussed above have focused mainly on large firms. Coleman and Cohn (2001: 81) argue that some of the most interesting questions in SME finance relate to the extent to which the theories of corporate finance fit the SMEs. These researchers question whether these theories, which were developed within the context of large and publicly owned firms, actually work when they are applied to small firms. Rajan and Zingales (1995: 1424) indicate that although the study of the capital structures of listed and large firms may be of the greatest importance to the financial community, the interests of academics are broader. Academics are interested in studying the whole universe of firms and not just large firms.

Daniel et al. (2006: 210) point out that in the case of small firms, the expected costs of bankruptcy is quite high and the expected costs of financial distress may outweigh any potential benefits from tax shield. Also, the advantage of the tax shield of debt is limited for small firms. Many small firms have limited revenues and the variability of their operating income can be quite volatile. Therefore, potential benefits of tax shields of interest payments remain doubtful. This is consistent with the results of a study by Sogorb (2002) which finds that the fiscal advantage of debt cannot be applied in the SME context because small firms are less likely to be profitable and therefore may not be able to use debt in order to get tax shields. Moreover, the main advantage of debt, the tax shield, can be especially complex to assess in new SMEs where business income is taxed as personal income.

Michaelas et al. (1999: 131) in addition, reveal that the

\[ t = \text{the marginal tax rate.} \]

(Correia et al., 2005: 7).
minimisation of the cost of capital and maximisation of profitability through the use of debt finance might not hold for small firms. Small firms find it difficult to borrow from commercial banks for a variety of reasons such as risk. When they are able to borrow from banks, the costs of debt financing for small firms are usually higher than those of large enterprises due to their higher credit risk. The reliance on debt to finance investment purposes therefore negatively impacts on the profitability of small firms.

In Zimbabwe, interest rates on lending are very high compared to the rates in developed countries. According to Madera (2010) the huge appetite for funding and low liquidity levels since the introduction of the multiple currency trading system has resulted in punitive lending rates on the market. Companies’ thirst for credit to better the decade-long recession points to a situation of a sustained high interest rate environment relative to those prevailing in the region. Prevailing lending rates range between London Interbank offered rate (Libor) plus 10 to 20% for 30 to 90-day paper. Libor is the world's most widely used benchmark for short-term interest rates. It is the rate at which the world’s most preferred borrowers are able to borrow money. It is also the rate upon which rates for less preferred borrowers are based. Rates are expected to continue oscillating within their current ranges, firming from current levels to ranges between Libor plus 10 to 25% for 30 to 90-day borrowings. Therefore, it is more difficult for enterprises, in Zimbabwe, to earn returns higher than the cost of debt compared to enterprises in developed countries. Consequently, it is hypothesised that there is a negative relationship between the use of debt and the profitability of small manufacturing firms in Zimbabwe.

METHODOLOGY

Value of a firm refers to the worth of a firm and its futuristic concept, that is, value is derived from a firm’s future benefits. Value of a firm to the owners of a firm is the worth of their equity in the firm. Together, owners and lenders view value as the total worth of the firm’s assets. This therefore entails that the value of a firm is equal to the total capital employed which is also equal to the employment of that capital. Any decisions that are made within a firm should be done to maximize the value of a firm and minimize the risk of the firm. Decisions that maximize the value of a firm result in greater returns being generated by the firm (Kriek et al., 2005: 108). In other words, it can be deduced that a change in the value of a firm can be determined by comparing returns to shareholders. An increase in returns to shareholders implies an increase in the value of a firm and a decrease implies a decrease in value, all things being constant.

Data collection

A quantitative research method of data collection was followed in conjunction with a descriptive research methodology which refers to a research methodology that is used to describe a problem or opportunity in detail. Self-administered questionnaires were used to gather primary data. The questionnaires were given to owners/managers of small manufacturing firms to complete and a fieldworker assisted with any misinterpretations. Self-administered questionnaires are free from interviewer bias and the respondents enjoy the convenience of completing the questionnaires at their own pace. In addition, respondents who were otherwise inaccessible were accessed.

The population of the small manufacturing firms for the research study was 400 adhering to the definition applied to this study (Central Statistics Office, Zimbabwe, 2006). The database for the selection of respondents was provided by the Ministry of Small and Medium Enterprises of Zimbabwe.

The participants were selected using the probability sampling method which constituted a method that used random selection to identify respondents. The sample constituted 200 respondents from the total population of small manufacturing firms identified. The formula below was used for the calculation of the sample since it is relevant to studies where a probability sampling method is used (Roberts-Lombard, 2006: 87).

\[ n \geq N / (1+Nd^2/10000) \]

where:

- \( N \) = Total population
- \( d \) = error estimate with a confidence interval of 95% (5% statistical error)
- \( n \) = sample size.

Therefore, \( n \geq 400/ [1+400(5)^2/10000] \) which implies that \( n \geq 200 \).

Data analysis procedure

The initial stage for data analysis was to determine ROA, ROE and debt ratio. ROA was used to determine the effect of leverage; ROE was used to determine the effect of debt on profitability whilst the debt ratio was to determine the capital structure. ROA was calculated by dividing income before interest and tax by average total assets and then multiplied by 100 to get the percentage. ROE was calculated by dividing net income with equity and multiplied by 100. Debt ratio is total debt divided by total assets/capital (Damodaran, 1999: 153 - 154).

An increase in ROE therefore reflects an increase in the value of a business. It should be noted that debt in the capital structure increases risk and can only benefit the value of the firm if

\[ \frac{EBIT}{TotalAssets} \]

is greater than before tax interest rate on debt. If not, leverage is negative and the value of the firm is negatively affected.

The data collected was analysed initially by the use of profitability ratios (ROE and ROA). The debt and profitability ratios were further regressed to determine the statistical significance of the relationship between debt and profitability of small manufacturing firms.

Regression equation

A regression equation was used to determine the pattern and strength of the relationship that exist between leverage and value/profitability of a small firm. To determine the impact of debt on profitability of a firm, a two-variable regression equation was used. The regression equation that was used is outlined below:

\[ y = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + \epsilon \]

where:

- \( y \) = dependent variable
- \( x_1 \) = independent variable
- \( \beta_1 \) and \( \beta_2 \) = coefficients
- \( \epsilon \) = error term
\[ P = \alpha + \beta_1 \text{Debt ratio} + \epsilon \]

Where \( P \) refers to profitability; \( \alpha \) is a constant; \( \beta_1 \) measures association between profitability \( (P) \) and debt ratio thus, the amount by which \( P \) changes on average when debt ratio changes by one unit \( \epsilon \) is the error or disturbance term. It captures the influences of all other variables affecting profitability, except the ones noted in the regression equation (Gujarati, 2003: 43 - 45).

**RESULTS**

The results were generated through the use of ratio analysis and regression analysis. These results are discussed in the sections that follow.

**Ratio analysis**

*Return on assets (ROA)*

ROA was calculated by dividing the firms’ operating profit (earnings before interest and taxes) by total assets. This ratio is often referred to as return on investment (ROI). It measures the overall effectiveness of management in generating profits with its available assets (Gitman, 2006: 68). In determining whether the use of debt (leverage) is positive, this percentage was compared to the before-tax interest rate on debt. If it is greater than the before-tax interest rate on debt, it means that profitability of a firm is being magnified consequently creating positive leverage.

For this study, the average ROA, calculated by dividing the total of all the ROAs for each firm that participated in the survey by the number of these participants was 69.8.

*Return on equity*

This refers to the return earned on the ordinary shareholders’ investment in the firm (Gitman, 2006: 69). This ratio is also expressed as a percentage and calculated by dividing net earnings (profit after interest and tax) by owner’s capital. The net earnings were calculated by subtracting interest and tax from operating profit. This figure was then divided by shareholders capital. The average ROE for this study was 41.5%.

*Debt ratio*

Debt ratio measures the proportion of total assets financed by a firm’s creditors. The higher this ratio, the greater the amount of debt used to generate profits (Gitman, 2006: 64). Debt ratio was calculated by dividing total debt by total assets. For the study at hand, the average debt ratio for the respondents was 0.17 (17%).

**Hypothesis testing**

Hypothesis testing refers to the determination of whether the hypothesis is accepted or rejected. This section tested the primary hypothesis (null hypothesis) of the study which stated that there is a negative relationship between debt usage and the value of a small manufacturing firm. Before the tests, were implemented a test of the model to determine if its significance was done. The model was as follows:

\[ P = \alpha + \beta_1 \text{Debt ratio} + \epsilon \]

The tests were administered to determine if the model measured a real life scenario. Table 1 shows the results of the test.

This study used a 95% confidence level to determine the significance of the tests. This means that for the tests to be accepted, the \( P \) values had to be less than 0.05. The \( P \) value \( (Pr > F) \) for the model was 0.001 which is less than 0.05, indicating that the model was statistically significant. Correlation testing was also done to determine if there was a relationship between variables. An extract of the correlation testing is highlighted in Table 2 that follows.

The correlation testing used obtained a figure 0.12836 which portrayed a weak relationship between profitability and amount of debt in the capital structure of small firms in Bulawayo. A relationship of 12.8% obtained portrays a weak relationship between profitability and debt. Table 3 is an extract of the regression procedure used to test the primary hypothesis.

Table 3 is an extract of the regression results used to test the impact of debt on the profitability of small manufacturing firms. The parameter estimate for the equation to determine the impact of debt on profitability of small manufacturing firms in Bulawayo was -0.00077596. Since the parameter was negative, it implied that the variables (debt and profitability) had a negative relationship which means that if the amount of debt in a firm’s capital increases, the profitability of the firm would be decreasing. The parameter estimate was negative and statistically significant. This implies that, a dollar increase in the value of debt would lead to a decrease in profitability. The null hypothesis which stated that there is a negative relationship between the use of debt and the profitability of small manufacturing firms in Zimbabwe cannot be rejected.

Debt was further broken down into short-term debt and long-term debt and the impact of both on the profitability of small manufacturing firms was investigated using the regression equation below:

\[ P = \alpha + \beta_1 \text{short-term debt} + \beta_2 \text{long-term debt} + \epsilon_1 \]

The results of the regression analysis when ROE was regressed against short-term debt and long-term debt
Table 1. Significance of the model on the impact of debt on profitability.

<table>
<thead>
<tr>
<th>Source</th>
<th>DF</th>
<th>Sum of squares</th>
<th>Mean square</th>
<th>F-value</th>
<th>Pr &gt; F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
<td>1</td>
<td>34.55659</td>
<td>11.51886</td>
<td>34.78</td>
<td>&lt;.0001</td>
</tr>
<tr>
<td>Error</td>
<td>83</td>
<td>27.48695</td>
<td>0.33117</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corrected total</td>
<td>86</td>
<td>62.04355</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 2. An extraction on Pearson correlation testing.

<table>
<thead>
<tr>
<th></th>
<th>Return on equity</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on equity</td>
<td>1.00000</td>
<td>-0.12836</td>
</tr>
<tr>
<td></td>
<td></td>
<td>0.2361</td>
</tr>
<tr>
<td>Debt</td>
<td>-0.12836</td>
<td>1.00000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>0.2361</td>
</tr>
</tbody>
</table>

Table 3. Parameter estimates for the regression results.

| Variable     | DF | Parameter estimate | Standard error | t-value | Pr > |t| |
|--------------|----|--------------------|----------------|---------|------|-----|
| Intercept    | 1  | 0.50808            | 0.11967        | 4.25    | <.0001 |
| Debt         | 1  | -0.00092595        | 0.00077596     | -1.19   | 0.001 |

Table 4. Regression extracts on short-term debt and profitability.

| Variable             | DF | Parameter estimate | Standard error | t-value | Pr > |t| |
|----------------------|----|--------------------|----------------|---------|------|-----|
| Intercept            | 1  | 0.50700            | 0.12522        | 4.05    | <.0001 |
| Short-term debt      | 1  | -0.00132           | 0.00123        | -1.07   | 0.004 |

Table 5. Regression extracts on long-term debt and profitability.

| Variable            | DF | Parameter estimate | Standard error | t-value | Pr > |t| |
|---------------------|----|--------------------|----------------|---------|------|-----|
| Intercept           | 1  | 0.48932            | 0.10579        | 4.63    | <.0001 |
| Long-term debt      | 1  | -0.00242           | 0.00178        | -1.36   | 0.001 |

using the above equation are presented in Tables 4 and 5. The result is the same as the test for the relationship between profitability and total debt. The impact of short-term debt on profitability is the same as for long-term debt. Short and long-term debt had statistically significant negative relationships with profitability. This means that the use of either short-term debt or long-term debt leads to negative leverage as shown by the parameter estimates which are negative.

These results are consistent with several studies that were done in developing countries. These studies found a negative relationship between debt usage and profitability of small firms. Such studies include Fatoki (2006), Kahle and Shastri (2004), Raj and Sutthisit (2003) and Zou and Xiao (2006). The use of debt was found to reduce the profitability of small firms, in other words, a negative leverage was experienced.

The findings of this study does not support the theoretical foundation of this study as was put forward by Modigliani and Miller in 1958 and corrected in 1963. The theory suggests that the use of debt leads to an increase in the value of a firm by reducing the cost of capital and magnifying returns to owners. The inconsistency can be attributed to high interest rates and high cost of funds.
prevailing in Zimbabwe.

Conclusions

The purpose of the paper was to investigate the impact of the use of debt on the profitability of small manufacturing firms in Zimbabwe. To determine whether leverage was positive or negative, regression analysis was used. The results of regression analysis indicated that the use of debt by small manufacturing firms resulted in negative leverage. The results obtained confirmed the null hypothesis postulated namely that there was a negative relationship between debt usage and the value of a small manufacturing firm in Bulawayo, Zimbabwe.

This study did not find any significant positive relationship between debt and the profitability of a firm. The results are inconsistent with the capital structure theory by Modigliani and Miller (1963) which formed the basis for this study. The theory argues that firms can use debt to lower their cost of capital and maximize the firm's value. Based on the results, the following are some recommendations pertaining to the use of debt by small manufacturing firms.

Use of debt

Selection of debt as a source of capital finance should be done in line with the costs and benefits associated with its use (debt). Costs such as interest charges, bankruptcy costs and agency costs should be weighed against the tax benefits of debt. The initial phase to assess the impact of using debt on firms' returns should start by comparing expected ROA to the estimated cost of debt. If the return on assets is higher than the before-tax interest on debt (interest rate), small business owners/managers can then go on to assess any other costs presented as a result of using debt. The reason for not using debt when the before-tax interest on debt is higher than the return on assets is that the use of debt would lead to a decrease in value/profitability (negative leverage) of a firm if sales decline. This can lead to bankruptcy because the firm will not be able to repay its debts.

Creation of a secondary security exchange

If the firms cannot merge to enjoy favourable leverage, alternatives to fund raising should be searched. Since the majority of these firms are so small that they cannot obtain funds from the public through a public share issue on the Zimbabwe Stock Exchange, a secondary stock exchange for small firms should be established. This is a duty for the government and the SMMEs Ministry since the small firms cannot do it themselves. This option was mentioned by the government but it needs to be implemented as soon as possible in order to assist the firms that are already in viable businesses. If implemented, small firms should therefore make use of this facility.

Long-term funding

Several small firms use short-term debt in their financing- overdrafts to be specific (according to the findings of this study), which are usually expensive. The loans that are offered by government are also supposed to be repaid in 6 months, which is relatively short. Instead of offering loans with a high concession, government can alternatively offer long-term loans at prevailing market rates. This can give SMFs time to stabilise and concentrate on the business rather than thinking about repayment of loans. Offering of short-term loans do not promote investments that have longer payback periods even if they are lucrative. Banks perceive small firms to be risky and therefore offer them short-term debt and to counteract that challenge, government should chip in and offer long-term debt financing to small firms. It should be reiterated here that long-term debt is relatively cheap, therefore accessibility of long-term debt can improve on the impact of debt on profitability.

Tax incentives

Since the study established that the use of debt, either short-term or long-term did not lead to positive leverage, the small business owners and the government should look at other ways that can lead to an increase in the value of firms. This is because the tax advantages of debt are being outweighed by the costs associated with it. To promote the prosperity of the small businesses, government should offer some financial incentives to promote entrepreneurship. Currently, the government is giving tax incentives to small manufacturing firms located in growth points. Instead of paying 30% tax rate, they pay 10% during the first 5 years of operation. Small manufacturing firms that export 50% or more of its outputs are being outweighed by the costs associated with it. To promote the prosperity of the small businesses, government should offer some financial incentives to promote entrepreneurship. Currently, the government is giving tax incentives to small manufacturing firms located in growth points. Instead of paying 30% tax rate, they pay 10% during the first 5 years of operation. Small manufacturing firms that export 50% or more of its outputs are taxed at 20%. These types of incentives should be offered to all small manufacturing firms regardless of their location.

Creation of a fair business environment

From the findings of this study, it was found that all SMFs that are making use of cheap government debt are enjoying positive leverage whilst SMFs that are making use of other sources of debt have negative leverage. This is unfair to all firms that do not enjoy the benefits of government debt. The government should therefore, substitute finance subsidies for other types of non-financial assistance such as training and red tape reduction. Not providing financial assistance to some
firms in the same sector creates an environment for fair competition to all participants. If the government feels that it has a responsibility to offer financial assistance, it should give it at the market rate and reduce extra costs that are incurred by small business owners. Besides being unfair, offering cheap debt also leads to less innovation, less competition, slow growth and few new job creations. By creating a fair playing ground, the government can promote fair competition and growth which can in turn lead to growth and more contributions to unemployment reduction and economic growth.

REFERENCES


