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Influence of Credit Limitations on the Growth of Small Enterprises in Fragile States: The case of Bosaso, Somalia

Abdullahi Bashir Abdinor

1. Economic lecturer at the faculty of Humanities and Social Science, Department of Economics, Red sea University, Bosaso, Somalia

Abstract:
In recent years, the development of small enterprises has emerged as a vital component of economic growth and poverty alleviation in many countries. This study aimed to investigate the influence of credit limitations on the growth of Small Enterprises in Bosaso, Somalia. To achieve this objective primary data was collected and analyzed employing content analysis and multiple regression analysis. The study revealed that a majority of small enterprises in Bosaso have access to credit, with Microfinance Institutions (MFIs) and banks being the primary sources. However, a significant minority still lacks access to credit, mainly due to weak banking infrastructure and insufficient collateral. Small enterprises face numerous challenges when seeking loans, including insufficient guarantor, Political instability, limited financial infrastructure, high interest rates, and limited collateral. These challenges hinder their ability to access credit, limiting their growth potential. Also, the regression analysis indicated a positive and significant relationship between credit availability and small enterprise growth. Conversely, the access to loan and the cost of credit were found to have negative impacts on growth. On the other hand, Small Enterprises in Bosaso employ various coping strategies to overcome credit limitations, including informal financing, asset-based financing, diversification of income streams, cost reduction measures, and seeking grants or donor funding. Based on these findings, the authors made several recommendations to address the challenges and enhance the growth prospects of small enterprises in Bosaso, Somalia. ‘

Keywords: Credit availability; challenges of access to loan, cost of credit, coping strategies; Growth of Small Enterprises; Bosaso; Somalia.

1. Introduction

In recent years, the development of small enterprises has emerged as a vital component of economic growth and poverty alleviation in many countries. The growth of Small Enterprises is closely linked to broader economic development in fragile states (Seyoum, 2024) through creating jobs, generating income, fostering entrepreneurship, and contributing to poverty reduction and economic stability. However, the growth and sustainability of these enterprises are often hindered by various challenges with access to credit being a fundamental requirement for their growth(Simba et al., 2024). Yet, in fragile states, this access is often constrained due to a combination of economic instability, political turmoil, and regulatory barriers (Carment & Samy, 2023). Also, entrepreneurs especially female in these areas face difficulties in accessing credit due to the lack of collateral, credit history, and the high risks associated with the environment. The very fact that vulnerable regions like Somalia often lack well-established financial institutions and face challenges in attracting foreign investment (Ahairwe, 2022) further demonstrates reasons for credit constraints.

These credit limitations have been shown to impede the growth of small enterprises (Aminkeng et al., 2024) by hampering their ability to invest in expanding their businesses, purchasing new equipment, and/or hiring additional staff (Chikalipah, 2020) and by misallocating resources (Jiapin Deng a, 2023). Also, lack of access to credit inhibits investment, job creation (AKANG & Department of Business Administration/Management. Akwa Ibom State Polytechnic, Ikot Osurua, 2023) and overall productivity (World Bank, 2019).

Bosaso, a bustling port city located in the Puntland Region of Somalia, has witnessed a steady rise in entrepreneurial activities over the past decade. Small Enterprises, ranging from shops to service providers, have sprung up, contributing to the local economy.

However, many of these enterprises struggle to access formal credit from financial institutions, leaving them with limited options for funding their operations. These constraints limit the ability of entrepreneurs to access the necessary capital to start or expand their businesses, thereby impeding economic progress and reducing opportunities for employment and income generation. To address these challenges and unlock the potential of small enterprises in Bosaso, a comprehensive understanding of the effect of credit constraints is essential. Cognizant of this, this study aims to investigate the influence of credit limitations on the growth of Small Enterprises in Bosaso, Puntland, Somalia. Specifically, the study aims to: 1) assess the level of credit availability for Small Enterprises (SEs) in the study area; 2) challenges of access to loan for SEs in the study area; 3) influence of cost of credit on the growth of SEs in the study area, and 4) coping strategies employed by SEs in Bosaso to mitigate the influence of credit limitations

By achieving these objectives, the findings of this study inform policymakers, financial institutions, and other stakeholders to design and implement targeted interventions to foster an enabling environment for small enterprise development in Bosaso, Somalia.

2. Review of Related Literature and Research Gap

The influence of credit limitations on the growth of Small Enterprises have been a significant topic of research in the field of economics and business. Numerous studies have examined how limited access to credit can impact the growth, innovation, and overall success of Small Enterprises. Ayala & Manova (2018) conducted a study investigating the link between access to finance and job growth, particularly in developing countries and fragile states. Their findings suggested that limited access to credit acts as a hindrance to the growth of small enterprises, as it restricts their capacity to invest in expansion and hire additional personnel. Fisman and Love (2004) also explored the impact of financial development on resource allocation across various sectors, including small enterprises in fragile states. Their research underscored that inadequate access to credit can lead to the misallocation of resources, consequently impeding the growth potential of small businesses.
Although not specific to fragile states, Chibbonta, D., & Chishimba, H. (2023) assessed the influence of access to credit on small enterprises in Mexico. Their results, while geographically distinct, demonstrated that enhanced access to credit positively influences the growth and profitability of small businesses, underscoring the critical role of financial resources. The (Opuala-Charles et al., 2023) contributed valuable insights into the ease of conducting business and economics growth in different countries, Establish a positive, significant association between loan availability and economic growth. Beck & Demirgüç-Kunt (2006) added to this body of knowledge by emphasizing that credit constraints significantly impede the growth and development of small and medium-sized enterprises (SMEs) and highlighted how the lack of access to credit inhibits investment, job creation, and overall economic development.

The World Bank's policy research report titled "Finance for all: policies and pitfalls in expanding access" (2019) underscored the importance of expanding access to finance for small enterprises. It documented the adverse effects of credit constraints on SMEs, including reduced productivity, limited expansion opportunities, and vulnerability to economic shocks and outlined policy recommendations aimed at improving access to credit for small businesses. Dean and Jonathan (2010) explored the role of microfinance in alleviating credit constraints for small enterprises. They discovered that while microfinance can be beneficial, it is not a one-size-fits-all solution. Some small businesses benefit more than others, emphasizing the need for tailored financial products.
Additionally, Banerjee & Duflo (2014) employed a directed lending program in India to assess firms' willingness to borrow more when credit constraints are eased. Their findings indicated that many small enterprises do indeed want to borrow more when given the opportunity, underscoring the significant barrier credit constraints pose to their development. Ackah, C., Görg, H., Hanley, A., & Hornok, C. (2024) delved into the impact of credit constraints on business practices in small firms in developing countries. Their research highlighted that credit-constrained firms tend to operate with lower capital, have limited capacity to invest in growth, and often face difficulties in improving productivity. (Ahmad et al., 2020) study highlights the critical relationship between access to finance and business performance, with higher access leading to improved labour productivity. Their findings highlight the importance of financial development initiatives in promoting economic growth and productivity within businesses.

These collective studies illuminate the multifaceted and pervasive effects of credit limitations on the growth and development of Small Enterprises, providing valuable insights for policymakers and practitioners seeking to support their advancement. While there has been substantial research on the influence of credit constraints on Small Enterprises, the influence of credit limitations on different types of small businesses especially in relation to fragile states is not widely studied. Another research gap pertains to exploring potential solutions and coping strategies related to credit limitations that could mitigate the negative effects of credit limitations. Also, to the best of the author's knowledge, this is the first study that aimed assess the influence of credit limitations on the growth of Small Enterprises in Bosaso, Somalia. Therefore, this study aims at bridging this research gap.

3. Methodology

A structured questionnaire was administered to a representative sample of Small Enterprises in Bosaso which included clothes and shoe shops, electronics shops, super markets and cosmetics. Given the challenging research environment in fragile states, mixed-method approaches that combine qualitative and quantitative data was employed as it is particularly valuable (Pfeifer & Kostova, 2020; Fafchamps & Schündeln, 2013.

1.1.Sample size

According to Bosaso Municipality (2024), the total number of registered Small and Medium Enterprises (SMEs) in the town was 2000 of which 250 are Small Enterprises (SEs). As this study focuses only on Small Enterprises, the sample size was determined from these 250 SEs using Slovenes' Formula:

$n = N \div (1 + N(e)^2)$

Where **n**: Sample size

N: Population size (total number of SEs)

e: Error term (in this case, 0.05 or 5%)

Inserting the values:

$n = 250 \div (1 + 250(0.05)^2) = 153$

After determining the sample size (153), the sample drawn from each three business types proportionately is as follows:

Table 1. Sample Proportionate

Business type	Population	Sample
Clothes and Shoe Shops	100	61
Electronics Shops	75	46
Super Markets	60	37
Cosmetics	15	9
Total	**250**	**153**

Source: Bosaso Municipality, 2024

Regarding sampling, stratified random sampling was used to select small enterprises across different sectors and size categories in Bosaso and representation of various demographic characteristics and business types was ensured within the sample.

3.2 Data analysis

Content analysis was used to extract relevant information from qualitative data sources. Multiple Regression analysis was employed to assess the relationship between credit limitations and growth of Small Enterprises in the study area. The regression equation represents the independent variable (credit constraints) and dependent (Small Enterprise growth) measuring income growth for small enterprises; the variables using regression and expressed as follows:

Growth of SEs (IG) = α+ β1 (credit availability) + β2 (Access to loan) + β3 (Cost of credit) + ε … (1)

IG= α+β1CA1+ β2AL2 +β3CC3+ ε …………………… (2)

Where: IG = Growth of SEs as measured by Income growth (respondents data from questionnaire).

CA1=the credit availability (independent variable) was measured whether SEs available getting to credit or not from financial institutions.

AL2=Access to Loan (independent variable) the all financial institutions required collateral to secure a SEs loan so we measured weather SEs getting collateral requirement and the challenge they face.

CC3=Cost of credit (independent variable) measure the costs of interest rates; travelling expenses etc.

B1-β3= the coefficient of independent variables,

α = Intercept that is the value of IG when all other variables take the value of zero,
ε = Error term. To test the model significance and relationship between access to finance and income growth of Small Enterprises, the researcher conducted regression and Correlation respectively.

3. Results and discussions

3.1 Demographic and financial profile of the respondents

As shown in Table 2 below, the gender distribution among the respondents is skewed towards males, with 67% being male and 33% being female, indicating that the study's sample has a higher representation of male entrepreneurs. The age distribution of the respondents is fairly evenly distributed, with the majority falling into the age groups of 24-29, 30-35, and 35 and above. This indicates that the study has representation from a range of age groups, which is important for understanding the dynamics of small enterprises in Bosaso. The educational background of the respondents is diverse, with the majority having a college or university education (56%) suggesting that a significant portion of the small business owners in Bosaso have at least some level of higher education, which could impact their business decision-making.

On the other hand, the types of businesses represented in the study include electronics shops, clothing and shoe shops, supermarkets, and cosmetics stores. Electronics shops and clothing shops are the most common types of businesses among the respondents, making up a significant portion of the sample (35%). The distribution of the number of years in operation shows that a substantial portion of the small enterprises in Bosaso have been in operation for 3-5 years, indicating a degree of stability in the business landscape. The revenue distribution demonstrates that a significant proportion of the businesses in the study fall into the 5,000-10,000 USD revenue range, with a substantial number reporting revenues above 10,000 USD. This suggests a diversity in the economic scale of the small enterprises. The majority of the respondents reported profit margins in the 0-10% range, indicating that a significant portion of small enterprises operating with relatively low profit margins.

Table 2. Demographic and financial profile of the respondents

Variable		Frequency	Percentage
Gender			
	Male	102	67
	Female	51	33
	Total	**153**	**100**
Age			
	18-23	13	8
	24-29	41	27
	30-35	46	30
	35 and above	53	35
	Total	**153**	**100**
Level of education			
	Illiterate	10	6
	Primary Level	21	14
	Secondary Level	36	24
	College/University	86	56
	Total	**153**	**100**
Type of business			
	Electronics shops	53	35
	Cloths & shoes shops	48	31
	Supermarkets	33	22
	Cosmetics	19	12
	Total	**153**	**100**
Number of years in operation			
	Less than 1 year	13	8

	1-2 years	30	20
	3-5 years	70	46
	6-10 years	40	26
	Total	**153**	**100**
Total revenue for the last fiscal year (in USD)			
	Less than 5,000	13	8
	5,000-10,000	70	46
	10,000-50,000	40	26
	Above 50,000	30	20
	Total	**153**	**100**
Estimated annual profit margin (% of revenue)			
	0-10	90	59
	11-20	50	33
	21-30	13	8
	More than 30	0	0
	Total	**153**	**100**

Source: Authors' Survey, 2024

3.2 The level of credit availability for Small Enterprises in Bosaso, Somalia

As shown in table below, 74% of respondents indicated that they have access to credit, while 26% stated they do not have access. This suggests that a significant majority of small enterprises in Bosaso, Puntland, Somalia, have access to credit, which is essential for their business operations and growth. However, a substantial minority (26%) still lacks access to credit. The major reason for this is due weak banking (50%) including poor credit history, insufficient financial documentation, and/or a lack of a strong banking relationship. This was followed by lack of collateral (27.5%) where a notable portion of Small Enterprises in the study area do not have the assets or collateral required by financial institutions to secure loans. 22.5% of the respondents stated ‘’underinvestment’’ as a reason for credit refusal, implying that some small enterprises do not meet the minimum investment criteria set by financial institutions, do not have a sufficient level of capital to support their loan applications and/or are not adequately prepared to present their investment plans to lenders.

Among those who have access to credit, the purposes for which they seek loans vary. 40% use credit for startup capital, 30% for working capital, and 30% for the expansion of their businesses. This diversity in loan purposes reflects the different needs of small enterprises, ranging from starting new ventures to sustaining existing operations and expanding their businesses. Regarding sources of credit, it appears that MFIs are the dominant source of credit for small enterprises in Bosaso, Somalia, with a significant share of 53%. Banks also play a substantial role, providing credit to 26.5% of the total sample enterprises. NGOs and "Other" sources of credit are less prevalent, contributing 9% and 11.5%, respectively.

Additionally, 83% of respondents reported facing problems with loan repayment, while 17% did not encounter repayment problems. This indicates that a majority of small business owners have experienced challenges when repaying loans including a short duration of repayment (30%), high monthly repayment amounts (40%), and high-interest rates (36%). This sheds light on the specific pain points that small enterprises in the study area encounter when dealing with credit, which informs strategies to make credit more accessible and manageable for them.

On the other hand, respondents' perceptions of their relationships with Financial Institutions (FIs) were assessed with 17% of the respondents considered their relationship with FIs excellent, 43% as good, and 40% as poor. The relatively high percentage of respondents with a poor perception of their relationships with FIs suggests room for improvement in communication, trust, and collaboration between small enterprises and financial institutions.

Table 3. Level of credit availability of Small Enterprises in Bosaso, Somalia

Variable		Freque	Percentage

		ncy	
Access to credit			
	Yes	113	74
	No	40	26
	Total	**153**	**100**
Reasons for credit inaccessibility			
	Weak banking	20	50
	Lack of collateral	11	27.5
	Underinvestment	9	22.5
	Total	**40**	**100**
Purpose of the credit			
	Startup capital	45	40
	Working capital	34	30
	Expansion of Business	34	30
	Other	0	0
	Total	**113**	**100**
Sources of credit			
	MFIs	60	53
	Banks	30	26.5
	NGOs	10	9
	Others	13	11.5
	Total	**113**	**100**
Problem with credit repayment			
	Yes	94	83
	No	19	17
	Total	**113**	**100**
Causes of the problem			
	Short duration	30	27
	High monthly repayment amount	40	36
	High interest rate	36	32
	Other	0	0
	Total	**94**	**100**
Relationship b/n SEs &FIs	Excellent	26	17
	Good	66	43
	Poor	61	40
	Total	**153**	**100**

Source: Author's Survey, 2024

3.3 Challenges of access to loan for SEs in Bosaso, Somalia

According to key informant interviews, access to loans for Small Enterprises (SEs) in the study area is beset by a multitude of challenges mainly:

1. Political instability and security concerns: Small Enterprises in the study area often grapple with political instability, armed conflict, and insecurity. These conditions create a high level of risk for lenders, discouraging them from investing in the region Attridge, S., & Gouett, M. (2021).
2. Limited financial infrastructure: Bosaso like many fragile towns in Somalia and elsewhere, has underdeveloped financial infrastructure, including banking and credit reporting systems. Financial Institutions in the study also lack of a robust legal framework and regulatory environment, which is essential for establishing and enforcing contracts. Additionally, there is limited access to financial information and a lack of financial literacy. The absence of these crucial components can make it challenging for SEs to access loans, demonstrate creditworthiness (IFC, 2019) and/or results in unfavorable loan terms/rejections (World Bank, 2020)
3. High interest rates: Due to the perceived risks and lack of formal lending options, SEs in the study area resort to informal lenders who charge exorbitant interest rates. This can lead to a cycle of debt for many small businesses Kamoga, J. (2024).
4. Limited collateral: Many SEs in fragile states may struggle to provide the necessary collateral to secure loans, as valuable assets are often at risk due to instability or lack of property rights. This lack of collateral can be a significant barrier to accessing credit. (IFC, 2019).
5. Foreign aid dependence: In some fragile states, the reliance on foreign aid can crowd out private investment, making it difficult for SEs to access loans from local financial institutions (OECD, 2021).
6. Limited capacity building programs: SEs in fragile states often require technical assistance and capacity building to improve their business operations and financial management. Limited access to such support can hinder their creditworthiness Gbatu, A. S. (2022).

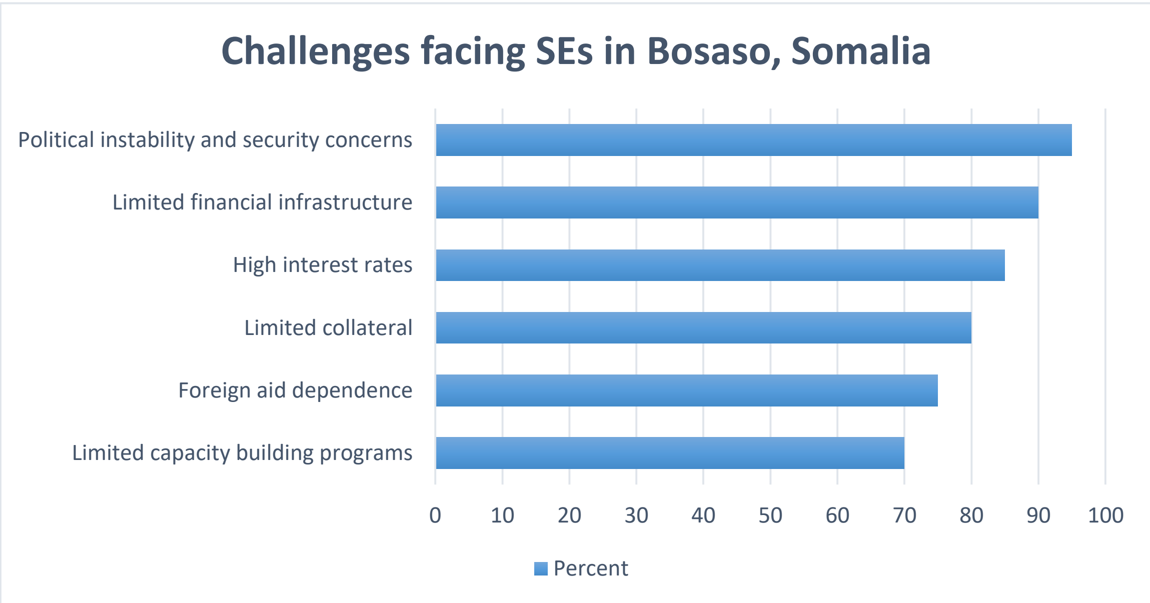

Figure 1. Challenges facing SEs in Bosaso, Somalia
Source: Author's survey, 2024

3.4 Influence of Credit Limitations on the Growth of Small Enterprises in Bosaso, Somalia

To assess the influence of Credit Limitations on the Growth of Small Enterprises in Bosaso, Somalia**,** a multiple regression analysis was conducted. The regression model is shown below:
Growth of SEs (IG) = α + β1 (credit availability of SEs) + β2 (access to Loan) + β2 (cost of credit of SEs) + ε ….Eq. 1
Regression analysis also produced correlation, coefficient of determination and analysis of variance (ANOVA). Correlation sought to show the nature of relationship between dependent and independent variables and coefficient of determination showed the strength of the relationship. Analysis of variance was done to show whether there is a significant mean difference between dependent and independent variables. The variance was conducted at 95% confidence level.
As shown in table below, the coefficient for "Credit availability" is 0.5, and it is statistically significant with a very low p-value (0.00). This suggests that there is a positive and significant relationship between credit

availability and small enterprise growth. In other words, as credit availability increases, small enterprises in Bosaso tend to experience higher growth.
The coefficient for "access to Loan" is 0.5, and it is also statistically significant with a very low p-value (0.00). However, the negative t-value (-5.23) indicates an inverse relationship between access to Loan and small enterprise growth. In this context, it suggests that as the requirement for collateral and guarantor decreases (or as collateral becomes more accessible), small enterprises tend to experience higher growth.
The coefficient for "Cost" is -0.24, and it is statistically significant with a low p-value (0.004). This negative coefficient indicates that higher costs (such as interest rates or fees) associated with credit have a negative impact on small enterprise growth. As the cost of credit increases, small enterprises tend to experience lower growth.
The constant term (3.39) represents the intercept of the regression equation and it is also statistically significant with a very low p-value (0.00), indicating that there are other factors not included in the model that influence small enterprise growth.

Table 4. Results of Multiple Regression analysis

Variables	**Coefficient**	**Std. Error**	**t**	**P>t**
Credit availability	0.5	0.08	6.02	0.00
Access to Loan	0.5	0.064	-5.23	0.00
Cost	-0.24	0.082	-2.92	0.004
_constant	3.39	0.55	6.17	0.00

a. Dependent Variable: Income Growth (IG)
Source: Authors' computation, 2024

3.5 Coping strategies employed by SEs to mitigate the influence of credit limitations

As shown in the below figure, Small Enterprises (SEs) in the study area employ 5 main coping strategies to mitigate the influence of credit limitations and continue their operations. These strategies are often adaptive and reflect the challenging economic and political environments they operate in:
1. Informal financings: Small Enterprises in the study area often rely on informal financing networks, such as family and community savings groups. These groups provide access to small amounts of capital without the need for formal collateral or documentation (Humphrey & Schmitz, 2010).
2. Asset-based financing: Some Small Enterprises in the study area use their existing assets, such as machinery or equipment, as collateral for short-term loans or credit from suppliers. This can be an effective way to access financing without relying on traditional loans Danladi, S., Prasad, M. S. V., Modibbo, U. M., Ahmadi, S. A., & Ghasemi, P. (2023).
3. Diversification of income streams: Some SEs diversify their income streams by offering various products or services to reduce dependence on loans. This approach helps them generate cash from different sources, reducing the need for external financing (Winkler, 2017).
4. Cost reduction and efficiency measures: SEs often implement cost-cutting measures and efficiency improvements to maximize their financial resources. This includes reducing waste, optimizing inventory, and streamlining operations (World Bank, 2020).
5. Seeking grants and donor funding: SEs in fragile states may seek grants or funding from international donors, NGOs, or development agencies to support their business activities. These funds can provide a financial lifeline when traditional loans are unavailable (OECD, 2021).

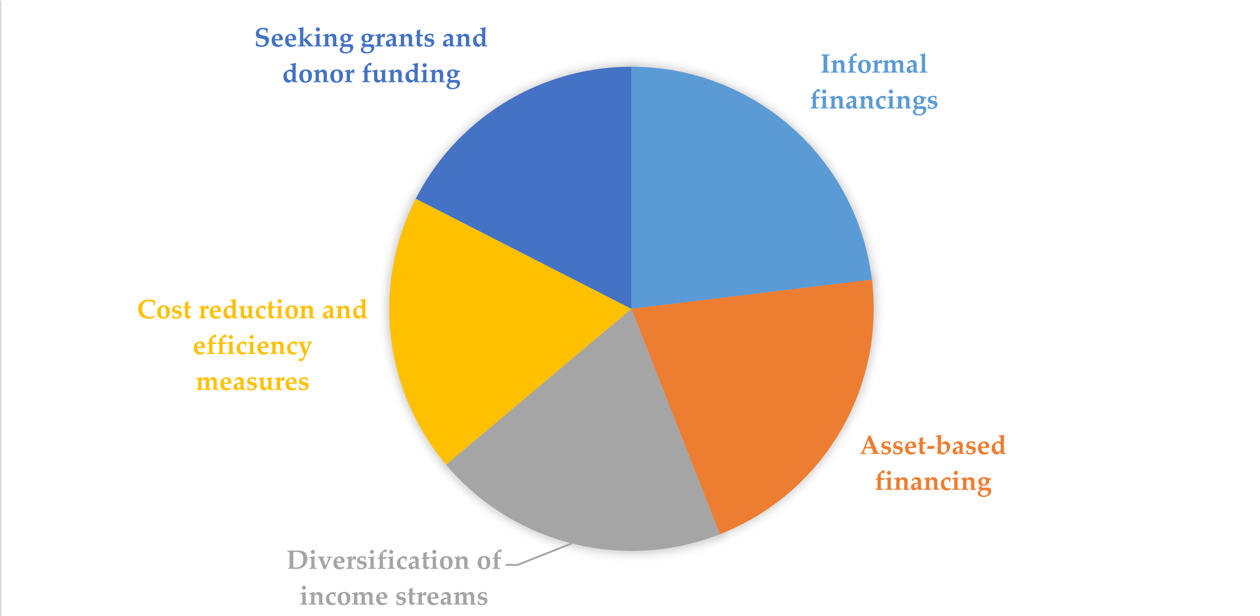

Figure 2. Coping strategies employed by SEs to mitigate the influence of credit limitations, **Source:** Author's survey, 2024

4. Conclusion and Recommendation

This study has shed light on the critical role that credit availability plays in fostering the growth and sustainability of small enterprises in fragile states, with a specific focus on Bosaso, Somalia. The findings of this research provide valuable insights into the challenges faced by small business owners in accessing credit, the impact of credit limitations on their growth, and the coping strategies employed to mitigate these limitations.

The study revealed that a majority of small enterprises in Bosaso have access to credit, with Microfinance Institutions (MFIs) and Banks being the primary sources. However, a significant minority still lacks access to credit, mainly due to weak banking infrastructure and insufficient collateral. Small enterprises face numerous challenges when seeking loans, including political instability, limited financial infrastructure, high interest rates, and limited collateral. These challenges hinder their ability to access credit, limiting their growth potential. The regression analysis indicated a positive and significant relationship between credit availability and small enterprise growth. Conversely, the requirement for collateral and the cost of credit were found to have negative impacts on growth. This highlights the pivotal role of credit accessibility in promoting the growth of small enterprises. On the other hand, Small Enterprises in Bosaso employ various coping strategies to overcome credit limitations, including informal financing, asset-based financing, diversification of income streams, cost reduction measures, and seeking grants or donor funding. Based on these findings of this study, the authors made the following recommendations to address the challenges and enhance the growth prospects of small enterprises in Bosaso, Somalia:

- Efforts should be made to develop a robust financial infrastructure in Bosaso, including improving banking systems, credit reporting mechanisms, and legal frameworks. This would enhance the creditworthiness of small enterprises and reduce the risk for lenders.
- Given the significant role of MFIs in providing credit to small enterprises, support should be provided to MFIs to expand their outreach and offer tailored financial products. This can include capacity building and regulatory support.
- Financial institutions should consider revising their collateral requirements to make credit more accessible to small enterprises. This could involve exploring alternative collateral options or providing guarantees for loans.
- Authorities should consider regulating interest rates charged by informal lenders to prevent excessive rates that can lead to a cycle of debt. This would protect small enterprises from exploitative lending practices.
- Small enterprises should be offered capacity building programs to improve their financial literacy, business operations, and credit readiness through partnerships with NGOs and government agencies.
- Encourage small enterprises to diversify their income streams and implement cost-reduction measures through business development and training programs.

- Facilitate the process for small enterprises to access grants and donor funding by providing information and resources on available funding opportunities and simplifying application processes.
- Efforts to stabilize the political situation and improve security in the region are crucial for attracting investment and reducing risk perceptions among lender.
- Foster collaboration between the public and private sectors to create an enabling environment for small enterprise growth. This can involve joint initiatives to improve access to credit and support for business development.

Overall, addressing credit limitations for small enterprises in Bosaso, Somalia, requires a multifaceted approach involving government policies, financial institutions, development organizations, and the private sector. By implementing these recommendations, policymakers and stakeholders can contribute to the growth and economic stability of small enterprises in this fragile state, ultimately enhancing livelihoods and reducing poverty in the region.

Supplementary Materials: Available on request

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