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Effects of Commercial Bank Loans on SME Growth: The Case of Morogoro Municipality, Tanzania

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Authors' contributions

This work was carried out in collaboration between both authors. Both authors read and approved the final manuscript.

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ABSTRACT

Background: Small and Medium-sized Enterprises (SMEs) are critical to economic development, contributing significantly to employment, income distribution, and poverty alleviation. Despite their importance, SMEs often face challenges in accessing finance, particularly from commercial banks. This study investigates the effects of commercial bank loans on SME growth in Morogoro Municipality.

Methods: The study adopted a cross-sectional research design, employing a quantitative approach to collect data from a sample of 92 SMEs operating in various sectors, including manufacturing, retail, services, and agriculture. The stratified random sampling technique was applied to ensure sectoral representativeness. Data were collected using structured questionnaires and descriptively analyzed.

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Results: The findings revealed that the majority of SMEs utilized commercial bank loans for business expansion (57.61%), upgrading infrastructure (55.43%), and developing new products or services (60.87%). However, a significant portion of SMEs also faced challenges in loan utilization, particularly in hiring more employees (44.57%) and investing in research and development (50.00%). The study demonstrated that effective utilization of loans positively impacts SME growth and financial performance.

Conclusion and Recommendations: Access to commercial bank loans is essential for the growth and sustainability of SMEs in Morogoro Municipality. However, barriers such as insufficient financial literacy and rigid loan terms limit their effective utilization. Policymakers should promote financial literacy programs and encourage banks to design more SME-friendly loan products. Additionally, reducing collateral requirements and offering targeted credit schemes could enhance SMEs' access to finance, fostering sustainable growth.

Keywords: SMEs; commercial bank loans; loan utilization; growth; Morogoro municipality; Tanzania.

1. INTRODUCTION

Small and Medium-sized Enterprises (SMEs) are widely recognized as key drivers of economic development, particularly in developing countries where they play a critical role in generating employment, fostering income distribution, and contributing to poverty reduction [1]. In Tanzania, SMEs contribute approximately 35% of the Gross Domestic Product (GDP) and employ over 40% of the labor force [2,3]. Their importance goes beyond economic output, as they also promote inclusive growth and social stability by providing opportunities to marginalized groups, particularly women and youth. However, despite their crucial role in the economy, SMEs often face significant challenges in accessing finance, particularly from commercial banks [4,5,6].

For, SMEs, access to external financing is essential. It enables them to invest in new technologies, expand their operations, and enhance their competitiveness in both domestic and global markets. Securing adequate financing, particularly through commercial bank loans, is vital for improving SME financial performance, sustainability, and long-term growth prospects [6]. However, in many developing countries, including Tanzania, access to formal financial services remains a significant barrier for SMEs. Financial institutions often perceive SMEs as high-risk clients due to their lack of collateral, limited credit history, and inadequate financial management practices [5,6]. These challenges hinder their ability to obtain the funds necessary for growth, forcing many SMEs to rely on informal financing sources that may not be sufficient to support large-scale investment or business expansion.

Moreover, we have noted that the utilization of commercial bank loans by SMEs is a critical area of research because it sheds light on the financial challenges faced by SMEs, but also provides insights into how these businesses manage and allocate the financial resources they can secure. Thus, understanding the use patterns of commercial bank loans among SMEs is crucial for several reasons. First, it provides an indication of the types of financial products and services that SMEs are most likely to use, as well as the specific challenges they face in accessing these services. Second, it offers insights into the effectiveness of commercial bank loans in enhancing the financial performance of SMEs. This includes evaluating the impact of bank loans on key financial metrics such as profitability, cash flow management, and business growth. Third, understanding loan utilization patterns allows policymakers, financial institutions, and SME managers to develop more targeted strategies for improving access to finance and fostering sustainable growth.

Although previous studies [4,5,6,7,8] have focused on the barriers SMEs face in accessing finance, such as high interest rates, stringent collateral requirements, and complex loan application processes, less attention has been given to the way SMEs utilize the loans they secure and how these utilization patterns influence their financial outcomes. This study seeks to address this gap by investigating how SMEs allocate the funds obtained from commercial bank loans and the subsequent impact on their business performance.

In addition, the Finance-Led Performance serves as the theoretical underpinning of this study. This theory asserts that access to reliable and timely financial services is crucial for improving the operational efficiency and performance of businesses, particularly SMEs [9]. Financial services, including loans and other banking products, are essential for enabling firms to invest in growth opportunities, optimize resource allocation, and enhance competitiveness. In the context of this study, the theory provides a framework for analyzing how access to commercial bank loans influences the financial success of SMEs in Morogoro Municipality. By examining the utilization of commercial bank loans, this study seeks to determine how financial inclusion contributes to SME growth, particularly regarding profitability, cash flow management, and business growth.

Given the growing recognition of SMEs' role in driving economic development, this study provides valuable insights into the use patterns of commercial bank loan and their implications for SME growth in Morogoro Municipality. Understanding use patterns of commercial bank loans is critical for policymakers, financial institutions, and SME managers, as it will help them in designing more effective strategies to improve access to finance, and support sustainable growth within the SME sector. By focusing on the practical implications of loan utilization, this study contributes to the broader discourse on SME financing and development, offering valuable insights for improving the financial ecosystem that supports SMEs.

2. THEORETICAL FRAMEWORK

The study is grounded in the *Finance-Led Performance Theory* which provides a theoretical framework by elucidating how access to financial services directly affects the growth and performance of SMEs. This theory postulates that the availability of reliable financial services—such as loans and other banking products—plays a vital role in enhancing a firm's operational efficiency and overall performance [9]. It argues that when businesses have access to adequate and timely financing, they are better positioned to invest in growth opportunities, boost productivity, and expand into new markets, including international ones.

Within the context of this study, the *Finance-Led Performance Theory* offered a perspective for examining the impact of commercial bank loans on the financial success of SMEs in Morogoro Municipality. The theory guided the investigation into how financial services, particularly those provided by commercial banks, facilitate SMEs' capacity to innovate, scale operations, and compete in both local and global markets. It also helped frame the analysis of how factors like foreign exchange rates, shaped by financial institutions, influence SMEs' ability to engage in international trade without being hindered by currency constraints.

Thus, the theory was particularly relevant in assessing the broader economic impact of SME access to finance. It informed the study's examination of how financial inclusion and the availability of loans from banks such as the National Microfinance Bank (NMB) in Tanzania, contribute to the overall economic performance of SMEs. Hence, by focusing on the relationship between financial services and firm performance, the theory shaped the study's approach to evaluating the role of commercial banks in fostering the growth and sustainability of SMEs in the region, as well as the challenges these enterprises face in obtaining the necessary financial resources.

3. MATERIALS AND METHODS

The study adopted a cross-sectional research design to assess the effects of commercial bank loans on SME growth in Morogoro Municipality. A cross-sectional design was appropriate for this study as it allows for the collection of data at a single point in time [10,11,12]. In the context of this study, provides a snapshot of the loan utilization practices of SMEs across various sectors, while providing a cost-effective and time-efficient means of data collection. Primary data was collected from 92 SMEs, selected using a stratified random sampling technique to ensure adequate representation of enterprises across various economic sectors. This sampling method was chosen to account for the heterogeneity among SMEs in Morogoro Municipality and to reduce the risk of sampling bias [13]. Stratified random sampling divides the population into subgroups, or strata, based on specific characteristics—in this case, sectors of operation—and then selects a random sample from each stratum. This method ensured that SMEs from the manufacturing, retail, services, and agriculture sectors were proportionately represented, making the findings more reliable and generalizable [14]. The collected data was descriptively analyzed using SPSS version 25, a powerful tool for statistical analysis [15]. Descriptive statistics was used to generate frequencies, means, and percentages, which were used to summarize the SMEs' loan utilization patterns. This type of analysis was critical in providing an overall understanding of how SMEs in Morogoro Municipality utilize commercial bank loans, as well as the outcomes of their utilization.

4. RESULTS AND DISCUSSION

The study aimed to determine the effects of commercial bank loans on SME growth. Research establishes that the effectiveness of loan utilization is crucial as it directly influences business growth and profitability [16]. Thus, by analyzing how SMEs use these loans whether for expansion, inventory, or other productive activities the study assesses the effectiveness of the financial support provided by NMB Bank. It is important to note that, effective utilization typically leads to improved economic outcomes, while poor utilization might result in minimal or negative impacts on financial performance [17].

Additionally, understanding loan utilization helps identify challenges that SMEs might face, such as a lack of financial literacy or inadequate business planning, which can hinder the productive use of funds. Thus, the findings of this study would be valuable for financial institutions and policymakers to tailor loan products better and provide the necessary support to ensure that SMEs maximize the benefits of commercial loans. Hence, NMB Bank can improve loan effectiveness by addressing these issues, thereby contributing to the growth and sustainability of SMEs in Tanzania. Table 1 presents the study results.

Investment in new technology: The utilization of commercial bank loans for investing in new technology is endorsed by 55.43% of SMEs, indicating that over half of the respondents leverage loans to acquire new equipment. This reflects a significant interest in modernizing technological capabilities, which is crucial for maintaining competitive advantage and improving operational efficiency. However, 34.78% of respondents disagree with this use of loans, and 9.78% remain neutral. The mean score of 3.25 suggests a moderate level of agreement on this point, while the standard deviation of 1.298 indicates some variation in responses. This variation could be attributed to differences in SMEs' technological needs and priorities across different sectors. The study results align with the findings of Msomi [18] which has shown that SME's value chain have increased their borrowing needs for investment purposes. In addition, the study by Osano and Languitone [7] emphasized that access to finance allows SMEs to undertake productive investments and contribute to the development of the national economy and alleviation of poverty in most Sub-Saharan African (SSA) countries.

Expand business operations: Expanding business operations is the most prevalent use of commercial bank loans, with 57.61% of SMEs indicating that they use loans for this purpose. This finding underscores the importance of growth and expansion in the SME sector, suggesting that businesses are actively seeking to increase their market presence and operational scale. The mean score of 3.50 is the highest among the categories, reflecting strong agreement on the role of loans in facilitating expansion. The relatively low standard deviation of 1.218 suggests that responses are quite consistent, with most SMEs aligning on the significance of this use of bank loans. The study results align with the findings of Rankho and Macha [19] which have shown that the credits provided by commercial banks to SMEs help expand their business.

Table 1. Utilization of commercial bank loans by SMEs

Statements	Agree		Neutral		Disagree		Statistics	
	n	%	n	%	n	%	$\bar{x}$	σ
Invest in new technology (i.e., the bank loan used to acquire new equipment)	51	55.43	9	9.78	32	34.78	3.25	1.298
Expand business operations	53	57.61	18	19.57	21	22.83	3.50	1.218
Hiring more employees	41	44.57	23	25.00	28	30.43	3.16	1.234
Develop new products or services	56	60.87	18	19.57	18	19.57	3.30	1.299
Upgrade infrastructure facilities	51	55.43	14	15.22	27	29.35	3.46	1.354
Research and development (to explore new market opportunities)	46	50.00	17	18.48	29	31.52	3.64	1.245

Source: Field Data (2024)

Hiring more employees: The study found that about 44.57% of SMEs agreed to use the bank loans accessed to increase the number of business employees. However, this relatively lower percentage indicates that while hiring employees is important, it is not the primary focus for many SMEs when it comes to loan utilization. Additionally, a significant portion of SMEs, 30.43%, disagreed with using loans for this purpose, while 25.00% remained neutral. The mean score of 3.16 reflects a lower level of agreement, and the standard deviation of 1.234 suggests moderate variability in how SMEs prioritize hiring through loan funding. The study result is in line with the findings of Rankho and Macha [19] which have shown that different commercial bank services are useful for increasing the number of employees for the business.

Develop new products or services: Developing new products or services is another prominent use of commercial bank loans, as indicated by 60.87% of SMEs. This study result implies a strong focus on innovation and market differentiation among SMEs in the study area. The mean score of 3.30 reflects a positive consensus on the importance of loans for product and service development, with a standard deviation of 1.299 showing some variation in responses. Thus, the SMEs' commitment to developing new products or services through bank loans demonstrates an emphasis on enhancing market competitiveness and responding to consumer demands. Several related studies have indicated that by investing in new technology, SMEs contribute to economic development by discovering new products/markets [19,20,21].

Upgrade infrastructure facilities: The study result found that about 55.43% of SMEs use NMB bank loans to upgrade their infrastructure facilities. The study result reflects a substantial investment in improving the physical and operational infrastructure necessary for business growth. The mean score of 3.46 indicates a relatively high level of agreement on this use of loans, and the standard deviation of 1.354 suggests some degree of variability in responses. In Tanzania, for instance the study of Rankho and Macha [19] found that most of SMEs use bank loans to upgrade the technological infrastructure to improve the ease of doing business. Therefore, in this study, it was found that upgrading infrastructure is crucial for supporting expanded operations and ensuring efficient business processes, thereby making it a significant area of loan utilization for SMEs.

Research and development: Research and development (R&D) is the highest-scoring category in terms of mean score, with 50.00% of SMEs using loans for this purpose. This emphasizes the role of R&D in exploring new market opportunities and fostering innovation. The mean score of 3.64 indicates a high level of agreement on the importance of loans for R&D activities, despite 31.52% of respondents disagreeing with this use of funds and 18.48% being neutral. The standard deviation of 1.245 suggests that while R&D is valued, there is some variability in how SMEs approach this aspect of their operations with bank loans.

5. CONCLUSION

This study has provided significant insights into the effects of commercial bank loans on ME growth in Morogoro Municipality. The findings highlight that SMEs use bank loans for various purposes, including expanding business operations, investing in new technology, upgrading infrastructure, developing new products, hiring more employees, and research and development (R&D). Of these, expanding operations and R&D were identified as the most prominent uses, emphasizing the importance SMEs place on growth and innovation. The results also suggest that while SMEs recognize the importance of external financing in improving their financial performance, the extent of loan utilization varies across different sectors and business priorities. Over half of the respondents use loans to invest in new technology and upgrade infrastructure, which is critical to enhancing operational efficiency and maintaining competitiveness. However, there is notable variability in how SMEs prioritize these investments, reflecting the diverse nature of their financial needs and objectives. The study also underscores the need for financial institutions and policymakers to tailor loan products and support services to the specific needs of SMEs. By understanding how SMEs allocate loan funds, financial institutions such as the National Microfinance Bank (NMB) can offer more targeted and effective products that address challenges like limited financial literacy and inadequate business planning. Moreover, the Finance-Led Performance Theory has proven relevant in this context, demonstrating that access to timely and reliable financial services is crucial for improving SME performance.

However, for SMEs to fully leverage the benefits of bank loans, complementary support in financial management and capacity-building is essential.

6. POLICY IMPLICATIONS

The findings of this study on the effects of commercial bank loans on ME growth in Morogoro Municipality have several important policy implications that can enhance the effectiveness of financial services for SMEs and contribute to their sustainable growth. These policy recommendations are aimed at addressing both the financial challenges SMEs face and improving the broader business environment in which they operate.

i. **Improving Access to Tailored Financial Products for SMEs:** Given that SMEs have varying needs based on sector and scale, policymakers should encourage financial institutions to develop more tailored financial products. The study revealed that SMEs prioritize expanding operations, investing in technology, and engaging in R&D. Therefore, loan products that are customized to support these specific areas—such as low-interest innovation loans or equipment financing programs—could better meet the needs of different enterprises. Policy initiatives could incentivize banks to innovate these offerings through tax credits or public-private partnerships.

ii. **Strengthening Financial Literacy and Capacity-Building Initiatives:** The study identified variations in loan utilization among SMEs, some of which could be linked to inadequate financial literacy. This suggests that many SMEs may lack the skills needed to effectively manage loan funds. Policymakers should thus focus on improving financial literacy and business management skills among SMEs through dedicated training programs. Such initiatives could be coordinated through local governments, business associations, or financial institutions, ensuring that SMEs maximize the value of the loans they receive and enhance their overall financial performance.

iii. **Incentivizing Long-Term Investments in Technology and R&D:** The study showed that while many SMEs use loans for technology investments and R&D, not all enterprises are equally committed to these critical areas for long-term competitiveness. Policymakers should incentivize technology adoption and innovation by offering subsidies, grants, or tax breaks for SMEs investing in new technologies and R&D. This could encourage a greater focus on modernization and innovation, leading to improved productivity and business expansion in the SME sector.

iv. **Reducing Barriers to Finance for SMEs:** The persistent barriers to accessing commercial bank loans for SMEs, such as stringent collateral requirements and high interest rates, remain significant challenges. Policymakers should promote reforms that lower these barriers, such as facilitating credit guarantee schemes or reducing the collateral requirements for smaller, high-potential enterprises. Moreover, the central bank could explore implementing policies that provide more favourable lending conditions for SMEs, such as caps on interest rates or reduced risk-weighted capital charges for banks lending to SMEs.

v. **Promoting Public-Private Partnerships (PPPs) to Support SME Growth:** Public-private partnerships could serve as a platform for developing and delivering financial services targeted at SMEs. By collaborating with financial institutions, the government can share the risk associated with lending to SMEs while ensuring that financial products remain affordable. Additionally, PPPs could foster innovation in financing models and encourage investment in sectors critical to economic development, such as agriculture, technology, and manufacturing.

DISCLAIMER (ARTIFICIAL INTELLIGENCE)

Author(s) hereby declare that NO generative AI technologies such as Large Language Models (ChatGPT, COPILOT, etc.) and text-to-image generators have been used during the writing or editing of this manuscript.

COMPETING INTERESTS

Authors have declared that they have no known competing financial interests or non-financial interests or personal relationships that could have appeared to influence the work reported in this paper.

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