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# AIDING SMALL BUSINESS IN AGRICULTURE MARKET CENTERS

by

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The first part of this paper is devoted to describing the changing complexion of small business in agricultural market centers in response to increased demands from farm communities for locally produced goods and services. It is based upon observations made during a study of the impact between 1967 and 1971 of agricultural modernization on non-agricultural employment in southern Nueva Ecija province. This study suggests that small business in rural areas is by no means unresponsive to changing agricultural productivity and that it offers significant opportunities during the 1970s for absorbing rural labor.

The second part of the paper discusses a proposal by which a target group of progressive small businesses might be aided through government policy. The assistance proposed is through an incentive program rather than through direct governmental assistance. Because "small business" embraces a wide area, it is necessary to define carefully what one is discussing. This is especially true here since, we are presenting a perception of a transition period.

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DEFINING BUSINESS TYPES

For the purposes of this discussion two related sets of definitions will be used: (i) producers versus businessmen and (ii) household firms, producers-aspiring-to-become-businesses, and businesses. Initially, for simplicity in exposition, the discussion will be restricted to manufacturing though it will later be extended to cover commerce, services, and transport.

"Producer" refers simply to people who make things, the act of production. "Businessman" is a concept which excludes the producer and embraces not only the classically defined entrepreneur and manager functions but additionally an explicitly separated function, the ability to keep accounts. As a practical matter in rural areas, as in most other parts of the world, provision of capital normally attaches to the "businessman". It will be seen below that it is important to keep to the fore in ones thinking the appreciation that the businessman is not always the provider of capital. Nevertheless, for the moment let us define the attributes of the "businessman" as being the provider of: entrepreneurship, managerial ability, capital, and the ability to keep accounts.

In accordance with standard economic concepts, the businessman hires producers. But what is central is that the producer need not be, indeed often is not, a businessman. That is, we will here narrow the definition of a "producer" to correspond to a common phenomenon in rural area: an individual craftsman, possibly utilizing a helper or two, for whom there are no other functions than production. He is skillful, single orders come to him, a downpayment covers materials costs, wages are paid the helper when the item is paid for, tools represent an insignificant amount of capital, and the home is used as a workshop. In other words, we are defining such "firms" as involving entrepreneurial, managerial, and capital-providing skills at a "sub-economic level". Indeed, the point of the next set of definitions is to formalize the process, common throughout the world, wherein a skillful "producer" tries to expand because his products are in demand but sooner or later fails precisely because he lacks the skills of a businessman. He perceives himself as having a business and therefore as being a businessman -- but he is not. He is just a producer.

Among the reasons it is necessary to make the next set of definition is to avoid the pitfall of the term "family firm". In the countryside all firms are family firms (even when they are incorporated). Thus, we distinguish the following: the "household firm" is one whose activities are essentially carried out by the household and, almost invariably, in the household -- under it, if you are in the Philippines. The "business" is a firm which utilizes resources beyond those of the household and has done so for a number of years. In other words, it has been demonstrated by the passage of time that the firm has the capacities of both businessman and producer.

The third category is the "producer-aspiring-to-be-a-business". This is the currently interesting group since its ranks are growing and since it could significantly broaden the base of economic, social, and political leadership in communities in the countryside. Its definition is implicit. In having attempted to utilize resources from outside the household he has demonstrated entrepreneurial ability. We will assume it also implies he is a skilled producer with an expanding market. Whether he has the ability to manage, keep accounts, and mobilize and utilize capital are unknowns, only to be tested by time. Most"producers-aspiring-to-be-a-business" prove lacking in one of the latter three skills, fail, and fall back to being producers. Some succeed and become a business. It can now be seen that the household firm is by definition that of a "producer" for it is only when he has tried to utilize outside resources that it is demonstrated that he has more than producers' skills.

THE CHANGING COMPLEXION OF SMALL BUSINESSES

With the definitions behind us, it is now possible to move on to discussion of the pattern of entreprenuership and changes in it in the Gapan-area over the past decade or so. The results will produce no surprises for the small industries experts, for the pattern and changes are little different from those observed the world over. However, they raise interesting questions for public policy.

First, a description of what will be termed the traditional pattern of non-agricultural entrepreneurship and economic activity in an agriculture market center: Town activities can reasonably be summarized as a dichotomy between the small shop keepers performing traditional retail activities and the "businesses" which by nature require significant capital and therefore are exclusively in the hands of landed (or Chinese) families -- rice milling and trading and perhaps construction materials supply (lumber yards). Transportation by truck attaches to the latter activities. It should also be noted that manufacturing took place primarily in the barrios - e.g., tailoring and housing materials -- or in larger economic centers, sometimes in factories -- e.g., wooden plows and harrows, textiles, metal roofing sheets. It should be noted that this "traditional" pattern should not be confused with the "self-sufficient barrio pattern" of the Z-goods model. The factory textiles and metal roofing are the more obvious substitutions for barrio production that are already assumed. In short, we are assuming a national economy and some specialization of production so far as the farming communities are concerned. We are not dealing with a "peasant economy".

This was the situation in the Gapan-area after the war. By 1961 the pattern still obtained: there was the usual market and small shops plus a number of rice mills and two lumber companies. As signs of changes to come there were one furniture and sash-work manufacturer (traditional farm houses had no furniture beyond a bedding rack and a safe-keeping trunk), one iron-works (metal sash and grills), and 7 tailor shops.

In the ensuing decade growth of non-agricultural economic activity in the town reflected the impact of the rising trend of farm incomes, an impact that fell importantly on people with skills, whether or not they had capital or education. Farm families acquired more clothes. As the stock became larger, wardrobes were needed. Sala sets came into general use. As palay yields rose again in the late 1960s so did investment in housing. Metal roofing had come from Manila; but as wood replaced temporary materials in upper-story walls, locally-produced sash work (windows, frames, and doors) was needed. In the latter 1960s enclosure of the ground-floor with hollow-block and metal window grills became widespread. Thus, the 1960s witnessed a fundamental change in barrio clothing, furnishings, and housing. What is more, the production of these goods, which took place in town, was skill-dependent, not capital or education dependent. For reasons of location economics and "national economies of scale", most of these goods should continue to be produced locally rather than in factories for some years to come. (There is a considerable literature on the economics of such small-scale industries to support this assumption.)

On top of this demand from farm barrios for local manufactures, town demands were added -- from rice millers, agro-business, and the commerce and services sector, all of whom were doing well. The pattern of their demand for local manufacturers was essentially similar - clothing, furnishings and housing. By 1971 Gapan had 5 wood furniture and sash makers, 7 iron works, 10 house construction contractors, and 24 tailor shops, most of which had the characteristics of producers-aspiring-to-become-businesses. In addition, the smaller municipalities around Gapan that formerly came there for such products had spawned their own sets of such craftsmen-producers firms. It should be added that the capital-based industries showed similar growth, construction material supply firms increasing to four, while seven concrete products (hollow blocks and pipes) firms were established.

In sum, the past decade in the Gapan-area has amply demonstrated that once a certain threshold level of income is crossed in an agricultural community, new demands result for the products of local craftsmen -- primarily those relating to clothing, furnishings, and housing. In addition, it is noteworthy that, considering that the average palay yields of the area are still well below what they should be, the reservoir of unmet demands in these areas may be very much larger than those satisfied to date. Considering that the Gapan-area is a leading area in Central Luzon, which itself leads the country, it seems safe to assume we are studying an important phenomenon when we consider the entry of craftsmen-producers into the ranks of "producers-aspiring-to-become- businesses". The next section will consider their characteristics more closely.

## CHARACTERISTICS OF THREE TYPES OF MANUFACTURING FIRMS

The household firm in the Gapan-area may be characterized as having from 1 to 5 people engaged, predominantly family and relatives. It manages to eliminate a working capital requirement through using cash downpayments, supplier credits, and deferring wage payments. The fixed capital requirement is minimal since the home is the workshop and hand tools are used. No books of account are kept (a small "tong", maybe ₱30 to the BIR man suffices for him to fix up the records in his office since the law requires that accounts be kept). The education level of the producer is usually Elementary, though some have some high school training.

The "businesses" in town -- continuing to ignore the small shops of the commerce and services sector -- may be characterized as well-capitalized with owners typically having a college or professional education. These characteristics correlate of course with their being of landed or monied families. If they did not know how to control costs to begin with, they have enough capital to absorb initial losses and enough education to teach themselves how to keep books of account or to hire the required expertize. Their payrolls are not particularly large in businesses like rice milling and trading or construction materials supply -- total people engaged will range between 10 and 30, taking seasonal employment into account. They typically have city bank accounts and an adequate supply of liquid capital, which they are normally in a position to supplement through secured borrowings. By virtue of their backgrounds, they are at least potentially well-connected politically; but the majority of their PNB and DBP borrowings are probably commercially justifiable.

The recent strong demand for housing components and furnishings could have attracted "businessmen" into factory-type production but in general it has not. (One suspects that with so many craftsmen-producers, profit margins are far too tight to be attractive.) Whatever the reason, it is the "producer-aspiring-to-become-a-business" which has emerged, especially as house construction contractors, in the manufacture of furniture, wood sashwork, and iron-work, and, extending the frame of reference to transportation, in truck body manufacture and vehicle metal work of various sorts.

We will characterize the "producer-aspiring-to-become-a-business" by a high skill level, a low education level, and relatively weak experience in business matters. He is by definition high in either native intelligence or initiative, probably both. He has sustained a payroll of between 7-15 people for at least two years -- this requirement eliminates the "producers" who make a weak stab at expanding and then fall back to their household firm -- but is still very vulnerable to changes in economic conditions. He is undercapitalized and probably heavily in debt for both fixed assets (equipment) and working capital. Lacking land to secure a loan, he must pay 5% to 10% per month for arms-length borrowing in the informal capital market. And more often than not he does not keep books of account.

The impressive aspect of such "producer-aspiring-to-become-businesses" is that they have got as far as they have: they have demonstrated the ability to produce a good product, to be an entrepreneur, to manage men and materials, and to mobilize capital. The suggestive evidence is thus strong that a process of pre-selection has taken place that marks these men as unusually talented. Yet the weakness of their business training and inability to keep a complete set of financial accounts makes the odds heavy that they will sooner or later lose control of their costs or otherwise fail financially if hit by adversity. Alternatively, it could argued that, even if they avoid financial failure, the inability to utilize financial management to guide their business activities will limit growth possibilities which otherwise might be realizable.

## THE QUESTION OF HOW TO AID SMALL BUSINESSES

All of the types of firm we have been considering would qualify as small businesses. Aiding such businesses through public policies has rarely been achieved, despite much effort. We might justifiably draw a correspondence here between NACIDA and the household firm on the one hand. It is the case that NACIDA has extended tax relief to many household firms who have registered with it despite the fact they are in no sense "cottage industries". It has also extended loans to some of these Gapan-area household firms, especially tailors. This is all probably well and good. But such assistance does not reach up to the "producer-aspiring-to-become-a-business". Similarly, the richness of financing sources which the above mentioned banks constitute in Central Luzon fail to reach down into the ranks of these newcomers. The reason of course is the inability of the latter to provide the collateral present banking practices require. (It might be noted in passing that, if the Central Bank can provide a Loan Guarantee Fund for unsecured loans to agricultural producers through the rural banks there seems little reason why they could not do the same for non-agricultural producers.) And finally there are the efforts of the ISSI. Here, their sights are set on factory operations and, not unreasonably, they are reported as having a policy limiting their efforts to firms with 20 or more employees.

Thus, we find our "producer-aspiring-to-become-a-business, with his payroll of 7-15 and no collateral, is the man in the middle -- no present instruments of assistance reach him. Yet he seems an admirable and considerable part of the rural landscape as we look ahead across the 1970s. Assuming the experience of the Gapan-area in the 1960s may be a fair model of what is in store in other areas in the 1970s, one could argue a strong case for wanting to find some means to assist this group. It is perhaps best presented in the context of a comparison of all possible rural businesses, set against the co-equal questions, "who should be helped?" and "who could be helped?".

Let us assume a consensus that cottage industries should be aided. On the basis of the discussion immediately above one might further argue (i) "Businesses" should not be further aided since they can take care of themselves, although (ii) they should be aided if they move into factory-production operations such as ISSI feels it can help; (iii) producers-aspiring-to-become-businesses should be helped since they have proven entrepreneurial and managerial abilities, and (iv) household firms should not be helped since as a target group they have all the wrong characteristics -- there are too many of them and their individual abilities are unknown and highly variable. Perhaps the main point that comes clear in this line of reasoning is what an unusual and attractive group the producer-aspiring-to-become-a-business is as a target group. It is small and the element of pre-selection is strong. Unlike the household firm, which is an unknown or the "businessman" who may have been born to his success, the producer-aspiring-to-become-a-business has by definition unusual entrepreneurial ability and initiative and a proven capacity to learn. One could reasonably expect that, with help, he would continue to grow in stature and effectiveness in economic activities -- in short that this group could be the source of vital "new blood" in rural entrepreneurial circles.

Assuming agreement that this group should be aided, could it be? At the outset two unlikely prospects should be noted. NACIDA's orientation towards national marketing of specialty products makes it unlikely its operations could be effectively extended to this group which by nature serves a very local market. ISSI's similar orientation to producing for a non-local market, especially through factory production, makes it also ill-suited to assist this group.

It should perhaps be made clear at this point that a producer-aspiring-to-become-a-business still looks very much like a household firm. His investment in buildings is still minimal with production still in and around his house. He uses more equipment and operations are more diversified but his main need is to learn how to get better control over his total existing operations. But he is still serving a highly competitive, very local market in which factory-production probably would be uneconomic.

Having suggested that the more obvious existing agencies might be poorly suited to helping this group, we will now consider a positive check list of areas in which aid could be provided:

(i) Capital: More and cheaper capital would help in the short run. The long run viability of the firm would not be assured by it, however. Specialized mechanisms such as a Non-Agricultural Loan Guarantee Fund operating through the rural banks might profitably be considered.

(ii) Management and Marketing Skills in General: IDC-type workshops and technical assistance programs are good in principle but rarely work in practice. It is hard to see them being effective with this type of group.

(iii) Production Skills: In the highly-competitive, low-income market these producers face, it is hard to believe outsiders would be able to improve on the choice of product quality and choice of production technology made by the producers given the factor costs he faces, some of which are not even monetary. Such assistance efforts are also notoriously difficult to implement.

(iv) Labor Training: This is simply not a problem among craftsmen-based firms in Central Luzon.

(v) Financial Management Training: Such training through workshops and extension programs would be excellent for this group. But such programs have rarely been successfully implemented.

In sum, experience world-wide with technical assistance efforts to small firms has been so unsatisfactory, one hesitates to recommend it as the answer for aiding even a specific target group like the producer-aspiring-to-become-a-business group. So far as financing mechanisms are concerned, efforts to discriminate in favor of rural areas in order to improve regional and rural-urban balance seem to be in vogue and should certainly be encouraged. Something still needs to be done about the banking industry's insistence on fully-secured lending, understandable though it is.

## A PROPOSAL

The conclusion of the above discussion then is that there are no obvious efforts that could be made by direct government programs to assist the producer-aspiring-to-become-a-business as a target group. The economist's reaction then is to ask, might some incentive be devised that would have the desired effect? The following proposal was conceived after much puzzling over this challenge. It seems workable precisely because, like any incentive program, it is self-implementing.

The jist of the proposal is that, if CPA services were made deductible from the <u>net</u> tax obligation of firms with less than 20 employees -- up to a limit of, say, ₱150 annually --, the effect would be that CPAs would be pursuing the firms, selling them on the idea that it would be preferable for the firm to purchase ₱150 of their services than to give the same away in taxes. From the point of view of national revenues, the amount that would be foregone might well be small since it appears tax evasion has long since been systematized at this level. Indeed, one of the significant virtues of such a proposal to the small entrepreneur is that, since he must operate under some kind of system in any case, he would prefer a legal one to an illegal one. He would also be very glad to have some help with his books.

Turning now to a more systematic discussion of the proposal, it would involve a revision of the tax laws that would read approximately as follows:

> "Non-agricultural firms in rural areas with less than 20 employees may deduct from their net BIR tax liability up to ₱150 annually for services of certified public accountants".

On the basis of experience elsewhere in the world and discussion with entrepreneurs, CPAs, and others in Central Luzon, the principal implications of the proposal are as follows.

First, it is discriminating to an extent so far as the target group -- the producer-aspiring-to-become-a-business -- is concerned. The household firm which is now paying a flat ₱50 per annum plus ₱30 to the BIR man to fix up the official record will not be of great interest to a CPA. Indeed, implicit in the proposal is an assumption that CPAs will re-organize themselves to take advantage of the profit possibilities of large-volume-low-margin business. Largely selling their services as individuals to large firms and families now, they would have to be willing to become managers to some extent, hiring B.Sc.s in Commerce (Accounting) -- of which there seems to be a surplus -- who would help the small firms to set up their books of account and maintain them. Specifically, a CPA would have to organize and select his clients so that, say, 5 man-days a year of ₱12 per day employees' time would be sufficient to bring him a certifiable set of books at year end and reward him with perhaps ₱60-90 for his management abilities and professional signature. Thus, the household firm who only has ₱80 of direct and indirect payments to the BIR that could be shifted to CPA services is unlikely to be of interest to the CPA. By the nature of the economics of the situation he will address himself to larger firms, which include prominently the target group. It then only remains to impose some kind of ceiling -- perhaps on asset size -- to exclude "businesses" if they are deemed to not need such tax relief.

Those firms that would be of interest would be (i) those who were already large enough so they were paying out P150 annually, directly and indirectly, (ii) those who appeared to be promising future business clients, given a little help, and (iii) those whose books the CPA already helps prepare (and doctor) for free because of a sense of social obligation -- relatives, friends, and others who indebt themselves to the CPA simply by asking his help. The first two categories are not mutually exclusive, of course. The third is by no means an unimportant one, or so it has been reported.

Second, for reasons already discussed earlier in the paper, the proposal provides the entrepreneur with precisely the ingredient he needs to put his firm on a sound footing. Already proven to be a skilled producer, assistance with financial management will help him perceive and order the various facets of his business. Key among these is the understanding he will gain as to what is needed to avoid disaster in a downturn -- the importance of not going excessively into debt on equipment purchases, of not extending credit unwisely, of building up working capital so inventories can be maintained at economic levels, and of understanding and controlling his cash flow in general. This understanding of how to make himself less vulnerable will simultaneously put him on the road to understanding how to control his costs during normal times. Thus is his survival and his profitability aided as a local producer for a local market.

Third, the proposal contains the ingredients for helping those who have the innate ability to expand beyond the confines of their local market. This is because the CPA, institutionally, is the ideal channel through which to link the promising local firm to the services required if it is to grow further. The CPA can provide introductions to banking firms with the supporting documentation required for a loan application. He also becomes the financial advisor to the firm generally, introducing the producer-aspiring-to-become-a-business to modern concepts of marketing and management and helping him make any required institutional contacts as he needs them. And of course much the same thing can be said of his potential role in facilitating the entrepreneur's contacts with government -- the opportunities, the pitfalls, and the red tape maze.

A final point -- more obscure because it technically conflicts with the professional independence of the CPA -- is the likelihood that the CPA would _de facto_ join the management of the successful firm. He might participate in profits through a variety of devices that might or might not include covert stock ownership. But the point is that, once a CPA becomes involved with a growing firm, the process of success by nature will draw him closer to firm operations at precisely those times when it requires financial expertize. Thus is lifted one of the key constraints that tend to impose a ceiling on the growth of small businesses all over the world -- the inability of the one-man-firm to attract into decision-making skills beyond those of the owner himself. Those skills rarely include financial expertize which, as any commercial banker will attest, is the skill most typically lacking.

## TECHNICAL FEASIBILITY AND POLITICAL IMPLEMENTABILITY

Assuming the proposal is conceptually attractive, will it work in rural areas? Let us now extend the discussion to include producers-aspiring-to-become-a-business in any line of business, which especially draws in production of services (broadly interpreted) -- for example, restauranteurs, transport, and construction contractors. Judging from our experience in southern Nueva Ecija province in Central Luzon, it should work. There are CPAs -- most of the "businesses" use them. The greatest concentration is in the province capital, but the services seem to be available where demanded. There is abundant evidence that the producer-aspiring-to-become-a-business is acutely aware that inadequate control of his finances is of crucial importance to him. Indeed it seems possible, once given the initial P150 incentive, he would be willing to purchase more than this minimum amount in order to get his financial condition in order. In other words, there is evidence of both the means and the will to modernize the accounting systems among the target group. The authors' impression is that what is true today in Central Luzon is not too different from the conditions obtaining in all but the clearly lagging regions of the country.

The political implementability of the proposal presumably hangs mainly on a balancing off of the desire to foster economic growth in the countryside against the taxes foregone. The reasons for limiting the proposal to firms in rural areas are largely tactical -- if its broadened to include firms in the major urban areas, the legislation might not get passed, while if it is kept narrow, it might. Specifically, there are several current policy interests under which the proposal could be subsumed -- regional balance, labor-intensive industries, and rural-urban balance interpreted to pertain to encouraging employment opportunities in agricultural areas. (It must be underscored at this point that "rural" as used throughout this paper refers to the entirety of the "countryside" as the layman understands it, including its towns and cities. It is not at all the same as the official BCS definition of rural and <u>no official statistical series on "rural areas" coincides with the use of the term here</u>.)

The cost of the proposal in taxes foregone has yet to be calculated; nor has the level of incentives required. Presumably passage of tax relief legislation is as much a matter of timing as of substance. (The present seems singularly awkward.) But for any decision-maker seriously interested in stemming the flow of migration out of rural areas, the opportunity to effectively help promising small businesses should be attractive and eminently defensible in political debate if properly "packaged" conceptually. The economist should have little trouble in representing the benefits and costs in favorable terms and quantities for use in such decision-making and debate. The cost might well be low compared with existing operational programs for assisting business. Also, properly mobilized, the CPAs could constitute a significant lobby for the legislation.

<u>RECOMMENDATION</u>

On the basis of the above it would seem the first step needed towards implementation is research into the cost of the tax relief. This might usefully be done by an M.A. student, optimally in coordination with a government unit like the N.E.C. As economists, the benefits are equally of interest. But it should be recognized that quantifying them, with the statistical information available, falls more in the realm of "packaging" estimates for particular purposes than it does in the realm of science.