Small Enterprises and Development Policy in the Philippines: A Case Study

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This report presents an ex post evaluation of the Small and Medium Industries Program introduced in the Philippines in 1974, and reassesses the assumptions behind the programs. Its aim is to report on the Philippines' experience in a manner that it is hoped will be useful to those involved with such programs in other countries, as well as the Philippines, and who are interested in their relevance for industrial development. It examines the role of small industries in the development process, and how that role is affected by the structure of industrial tariffs and investment incentives and by policies towards agriculture. The part presenting the ex post studies reveals how specific programs—namely, in finance and extension—have worked out in practice, and what lessons emerge. It presents first hand evidence on risks and administrative costs, and shows how risks have led to capital market failures in the past. It makes the case for a relaxation of administrative constraints on the structure of interest rates together with a continuance or risk-guarantee and extension schemes to solve the risk problem—which would persist even if interest rates were not administered.

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The following report is one of a series of case studies and surveys of small enterprises in developing countries being financed by the World Bank's Research Committee (RPO 671-59). The aims of this research are to examine the role of small enterprises in providing employment and earnings opportunities, and to compare the experiences of different countries with various policies. Since it is part of a research project, the findings and views expressed in the report are not necessarily those of the World Bank.

The present study began in May 1978 in collaboration with the Ministry of Industry. The Development Bank of the Philippines, the Industrial Guarantee and Loan Fund, the Private Development Corporation of the Philippines and several private banks and investment houses were all most generous in providing information about their programs and experiences. The NCSO were also helpful in providing access to preliminary tabulations and worksheets, and the University of the Philippines' Institute for Small-Scale Industries gave us some of their research material. The help and co-operation of the staff of these institutions is gratefully acknowledged. It does not follow, of course, that they necessarily agree with the findings, or that they are in any way committed to them.

Carlos Singer did the background statistical work on the text tables and annexes, and was responsible for reviewing source material. Mrs. Fajardo was general consultant to the project, and directed the interviews and the review of file data reported in Chapter 6. Mrs. Tengra administered the research budget and contracts.
Comments and discussions on the earlier drafts of various chapters, and on the progress of the study, were kindly provided by Raphael Sison, Rodolfo Manalo and Andres Castillo of DBP; Tomas Tan of PDCP, Mrs. Mijares of IGLF, Evelyn Go (now with ADB), and Cesar Macuja; Tomas Paterno, Zoila Pedro, Nanette Agdeppa, Emanuel Almonte and Father Peron in the Ministry of Industry; and Al Berry, Bob de Vries, Peter Kilby, Mike Gould, Ted Hawkins, Larry Hinkle, Ian Little, Ernie Pernia, Paul Zuckerman, Joe Pernia, John Powers, Yung Rhee, Marcelo Selowsky, Khalid Siraj and Larry Westphal. Ernie Pernia was also kind enough to arrange for a seminar on the report at the University of the Philippines in July 1980.
SMALL ENTERPRISES AND DEVELOPMENT
POLICY IN THE PHILIPPINES: A CASE STUDY

The Main Report
I. INTRODUCTION AND SUMMARY

The Scope of the Report

1.1 Small enterprise programs have been introduced in many developing countries over the past thirty years, as an aspect of employment policy. The reasons, which are now familiar, are that small enterprises are held to be more labor intensive on average than large enterprises, so that a shift of investment towards them should help to raise the demand for labor. 1/ For the most part the programs have the following elements: 2/ finance, extension and advisory services, and vocational and management training. In some countries infrastructure, industrial estates and specialized marketing and technical services (e.g. in handicrafts) are also important.

1.2 Such programs naturally receive extensive analysis when they are being prepared and appraised, but rather less is known about how they work out in practice. In general terms it can be said that they have proved to be administratively costly and a significant risk for the financial institutions involved. But the information available is otherwise not concrete and, in addition, both the designs of the programs and what has been achieved vary greatly. This has led to proposals for (i) ex post evaluations of specific programs to determine whether the benefits outweigh the costs, and in what ways the costs and the risks can be reduced; and (ii) studies to reassess the assumptions behind the programs.

1.3 The following study of the Philippines experience was prepared with these two proposals in mind, and is accordingly in two parts. Part I presents an ex post evaluation of the financing and extension programs that were introduced in 1974 to assist small and medium industries, and Part II a reassessment of assumptions.

1.4 Something will be said shortly about the concerns that led up to the program being introduced in 1974, and why special interventions in favor of SSEs were felt to be necessary in order to raise output and the demand for labor. The question that immediately springs to mind is could such aims be achieved more effectively through a more efficient system of industrial tariffs and incentives, and through a broadly-based development of agriculture? These are, of course, the principal instruments at the government's disposal for raising output and employment. However, SSE programs are not intended to be a "second best" alternative, but instead to address specific sources of market failure that may, indeed, limit the effectiveness of such desirable policies. In the Philippines' case, the main sources of market failure were thought to be those due to the risks of loans not being repaid and to institutional shortcomings in the organized financial sector. As will be seen, the enterprise program was precisely designed to address these problems. It is obvious, of course, that the efficiency of the programs is not independent of the policy environment, since agricultural and industrial development

1/ See e.g. IBRD (1978) for a recent review, though the labor-intensity argument has been made for many years.

2/ The standard work on the subject is that of Staley and Morse (1966).
policies affect the prices and the product markets of both small and large enterprises; much of this report is in fact concerned with these relationships. But first it is necessary to understand the nature of the market failures that the program was designed to address, what problems were encountered, and what problems remain.

1.5 This is the task of Part I. It is in three Chapters, which draw on the records of the institutions involved, interviews with the head and branch office staff of over 30 institutions in the public and private sector, and interviews with the owners of over 80 enterprises that were either small or (it turned out) once small. The chapters contain an extensive analysis of risks and administrative costs, and of how both changed over time with the accumulation of experience and information within the institutions; they also show how risks are a function of the screening and supervision procedures adopted.

1.6 From a less operational viewpoint, there is perhaps more that is of interest in the reassessment of assumptions in Part II. The analysis in Part I provides the empirical basis for a reassessment of the first of four assumptions that commonly lay behind small enterprise programs. These concern:

   (i) The case, which some economists have questioned, for special interventions in the capital markets to support SSEs. Would not risk-reflecting interest rates, for example, accomplish the same end? or would they extinguish the market, as the recent research on uncertainty would suggest? if the latter happens, what policy options are open?

   (ii) The role of small industries in the development process: e.g. do they provide a growing source of output and employment, as is commonly assumed, and a base for industrial decentralization?

   (iii) How policies towards agriculture and industry affect the efficiency of small industries and (by implication) small industry programs. E.g. would a more broadly based development of agriculture and a more labor demanding system of industrial incentives raise output and economic efficiency in small industries?

   (iv) The conditions of employment, which in the Philippines as in most other developing countries are assumed to be deteriorating, and are most commonly cited as the prime reason for small enterprise programs.

A discussion of these assumptions takes up the five chapters (5 to 9) that comprise Part II. A further comment on each might be helpful.
The Assumptions of Small Enterprise Programs

1.7 Capital market failure due to uncertainty has been discussed extensively in the literature during the past 20 years, though mostly from a theoretical point of view. 1/ Also most studies are concerned with explaining the effects of uncertainty on the behaviour of capital markets rather than with reaching normative conclusions, which is the aim of the present study. But to consider the behavioral side first, how does uncertainty affect lending to small scale activities? The basic problem faced by most institutions arises from the difficulty of distinguishing between potentially "good" from "bad" projects. 2/ In situations where there is little knowledge or experience within the institutions for dealing with small businesses, the probability of financing "bad" projects reaches high levels. Risk-and cost-reflecting interest rates, assuming they were politically acceptable, would also reach high levels, sufficient perhaps to extinguish any institutional interest in the market. High interest rates raise the risks yet further by reducing the margins for contingency in the enterprises financed, and also raise doubts within the institutions about the capacity of the enterprises to service debts - i.e. there is the possibility of backward sloping supply curves. Thus most studies conclude that unregulated interest rates might not clear the market and credit rationing would remain. The question then arises as to what is the optimum policy.

1.8 If the risks were irreducible, the unavoidable conclusion would be that it is simply inefficient for institutions to finance small firms: any program would inevitably have high losses and, assuming these were due to "failed" projects, would also imply wasted investments. But further analysis shows that the probability of financing a "good" project increases

1/ A useful edition of papers can be found in Diamond and Rothschild (1978).

2/ As discussed in Akerlof's (1970) well-known study on the market for "lemons", "lemons," of course, referring to "bad" projects.
with the development of screening and appraisal procedures within the institutions, and as the branch staff become more knowledgeable about and experienced in dealing with small businesses in their local communities. The intrinsic riskiness of small firms, while undoubtedly higher than that of large firms, is not the over-riding determinant of the risks faced by the institutions. There is therefore a process of "learning by doing," and which provides an external benefit in that a large number of efficient businesses are no longer excluded from access to the organized financial sector by (also a large number of) less efficient businesses. In addition, the administrative costs of developing lending programs for small industries show significant economies of scale.

1.9 These factors, taken together, suggest that the best policy to pursue is one in which the structure of financial incentives acting on the capital markets offers prospects of long-run profitability, with risk-guarantee schemes acting to cushion the more immediate losses. This is the essence of our recommendations in the ex post evaluation in Part I, and in the theoretical discussion of interventions in Chapter 5 of Part II. Where we see a problem with the present policies towards small scale (in the Philippines as in other countries) it is that the financial incentives do not offer prospects of long-run profitability and, in consequence, even highly efficient small firms are frequently deprived of access to institutional credit in the private sector, and grow to depend greatly on government programs.

1.10 The second assumption noted above concerns the role of small enterprises in the development process, and requires less introduction. It is obvious that any small enterprise program if it is to be worthwhile rests on the assumption that the kinds of small scale activities to be assisted should be an efficient and growing source of output and employment; otherwise there would be an insufficient demand for the financial and non-financial services provided, and few benefits from "learning by doing" and economies of scale. In addition, certain characteristics of small enterprises need to be understood if the programs are to be helpful. It would, for instance, be unthinkable for an agricultural development program to be designed without first hand knowledge of the crops, cropping practices, markets, processing and input-supply arrangements being available. Similar remarks apply to small enterprise programs. Fortunately a number of studies (cited in the text) are available on this subject and Chapter 6 simply seeks to update and expand on them in various ways by presenting further interview data, and some recent information from the labor force and establishment censuses.

1.11 The third assumption noted above is often not made explicit in small enterprise programs, and is that more efficient (and also more labor demanding) policies towards agriculture and industry would make the programs themselves more efficient. (Put more technically, it is assumed that a shadow pricing analysis, allowing for the effects on markets of shadow and actual prices moving into alignment, would also show the programs to be
(economically desirable.) Our analysis in Chapter 7 supports this assumption on three grounds. **First,** it is shown that small industries are heavily concentrated in efficient sectors that have, on balance, been discriminated against under the system of industrial incentives and tariffs that were applied in the Philippines up to 1980. The analysis here draws on several studies published in the last 10 years on industrial and agricultural development policy in the Philippines, including Powers and Sicat (1971), ILO (1974), Bautista and Powers (1980), IBRD (1976 and 1980) and others. **Second,** a greater emphasis on a broadly-based development of agriculture (and which has been a feature of the development programs in the 1970s) would (and indeed already has) provide a greater stimulus to the development of the product markets in the provinces. The evidence is that small scale activities are highly responsive to these markets, and regions experiencing a rapid and broadly based growth of agriculture are also experiencing a rapid development of both small and large scale activities in the local urban centers. **Third,** as the above cited studies have shown, more efficient industrial incentives would also raise the demand for labor in large scale activities in the Philippines, since the present incentives have generally favored the capital intensive sectors and, in addition, offered a range of tax concessions on capital but not on labor costs. As far as we can see, a rising demand for labor in large scale should also stimulate the domestic markets for both small and large scale's products. We thus conclude that there is a positive association between the efficiency of leading sector policies and the efficiency of the small enterprise programs.

1.12 With respect to the fourth assumption - concerning the conditions of employment in the Philippines - the analysis in Chapter 8 shows that unemployment and underemployment rates have not been rising as commonly thought; in fact they have been declining steadily for over 15 years, according to all available measures, to quite low levels. What has happened instead is that labor supply and demand conditions have brought about declining real wages in many sectors, and undoubtedly declining real incomes for some families. On the other hand occupational shifts towards better paying forms of wage employment have been widespread, while there have been productivity and income gains among the self-employed in agriculture and industry. Thus as several writers have observed in other countries, the "employment problem" in the Philippines relates not to the lack but to the type of employment that is available, and the low incomes it provides. This conclusion is neither new nor surprising, but it does have implications for the way small enterprise programs are designed and implemented.
1.13 There is a tendency, for instance, in the Philippines as in other countries, to support only those firms that are "creating jobs." This is revealed in a preference for financing fixed assets over working capital, and for assisting enterprises that are expanding employment over those simply seeking modernization without such expansion. Furthermore, projects with incremental capital-labor ratios above a certain threshold are commonly rejected on the grounds that insufficient jobs are being "created" by the investments. All these policies, it seems to us, place an unnecessary constraint on what the programs might otherwise accomplish, and stem from a misperception about the levels of unemployment as opposed to the conditions of employment. It seems to us that there is nothing undesirable about financing profitable small firms even if no expansion of employment or of fixed assets is involved.

1.14 To provide further clarifications on this point, Chapter 9 presents a formal discussion of project selection criteria. In the labor markets faced by small enterprises in the Philippines, actual wages seem the best available approximation to the opportunity costs of labor, which vary greatly by region, over time, with skill level and with occupation. It follows from this that the right kinds of projects to support are those capable of providing for labor's income and earning a surplus after all other costs have been met; that is, we see nothing wrong with the rate of return to capital as a criterion for selecting projects. Where there are distortions in the product and factor markets, some modifications (using shadow prices) might of course be necessary. Since it would obviously be impractical to appraise thousands of very small investments using cost-benefit analysis, we have suggested instead that the research and evaluation departments of the larger institutions involved in the program might undertake the analysis periodically for samples of projects ex post; apart from its value in setting ground rules for lending (e.g. in which sectors to lend) such analysis would serve many other purposes connected with ex post evaluation and, in addition, provide first hand information on how industrial tariff policies affect small industries.

1.15 The conclusions to Parts I and II are brought together briefly in Chapter 10, and are set out in more detail at the end of each chapter. While most of the conclusions reached naturally relate only to the Philippines, an attempt is made throughout the report to make some points that may be relevant to those involved with SSE programs and employment policy in other countries.

Perspective on the Philippines' Small and Medium Industries Program

1.16 As a background to Part I of the report some comments on the circumstances that led to the introduction of the Small and Medium Industries (SMI) program in the Philippines might be helpful.

1/ A note on the use of the terms "Small and Medium Industries" and "small enterprises" is provided in the Annex to Chapter 1.