

## Mainstreaming SMEs through social enterprises

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### Introduction

Small and medium enterprises (SMEs) are regarded as key players for sustaining growth. This viewpoint has prompted the formulation of pro-SME policies based on three core arguments (WB 1994, 2002, 2004). First, SMEs enhance competition and entrepreneurship. This suggests that SMEs have external benefits on economy-wide efficiency, innovation, and aggregate productivity growth. From this perspective, direct government support to SMEs will help countries exploit the social benefits from greater competition and entrepreneurship. Second, SMEs are more productive than large firms, but financial market and other institutional failures impede SME development. Thus, pending financial and institutional improvements, direct government financial support to SMEs can boost economic growth and development. And third, expansion of SMEs boosts employment than the growth of large firms because SMEs are more labor

intensive. SMEs therefore are more effective in poverty alleviation than large firms.

It is argued here that social enterprises (SEs) are crucial to SME development and labor generation. SEs are small- and medium-sized commercial businesses that provide valuable social service to customers, and sustainable jobs and training for up to about 200 people. Their goal is to provide public goods to communities. What separates SEs from SMEs is that SEs unlike SMEs primarily address social issues.

In effect, SEs can help provide the needed stimulus for the development of SMEs. Each SE

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employs a blended workforce, consisting of nongovernment organizations (NGOs) and other community institutions working with production units, which are comprised of qualified tradespeople, cooperatives, apprentices, and industry experienced staff work.<sup>1</sup> SEs are also designed to work with production units—often households—from disadvantaged backgrounds. These stakeholders are often struggling to maintain work in competitive labor markets due to their disability, mental illness, age, cultural background, housing status, or other barriers.

By improving access to loans and technology, SEs help enrich the community by making necessary public goods available and affordable. When maximized to their full potential, SEs can provide jobs to community members. This *Policy Note* thus discusses the key policy variables necessary to support SE and SME development. It likewise examines the extent to which NGOs as well as international trade arrangements, such as the Asia-Pacific Economic Cooperation (APEC), can improve the business environment for SEs and SMEs.

### **The state of Philippine SMEs**

Despite various policies that aim to provide an enabling environment for SME development, the sector still faces various constraints that prevent it from realizing its full growth and potential (Aldaba 2009).

<sup>1</sup> Given the diverse nature of SEs, there are other ways in which SEs may have different purposes in social development, aside from employment creation. These other roles, including the creation of sustainable and resilient communities, however, go beyond the scope of this paper (see Dacanay 2012, for a survey of Philippine social enterprises).

An SME in the Philippines is defined as any business activity or enterprise engaged in industry, agribusiness, and/or services that has: (1) an asset size (less land) of up to PHP 100 million, and (2) an employment size of less than 200 employees. Based on these categories, it is classified as micro, small, or medium regardless of the type of business ownership (i.e., single proprietorship, cooperative, partnership, or corporation).

As of 2010, there were a total of 777,687 business enterprises in the Philippines. The small industries have been divided into two: the microenterprises (1–9 employees) and the small enterprises (10–99 employees). Of this figure, SMEs represented 99.6 percent with 774,664 establishments, while large enterprises represented 0.4 percent with 3,023 establishments. Microenterprises comprised 91.6 percent (709,899) of the total number of SMEs, while SMEs accounted for 8 percent (61,979) and 0.4 percent (2,786), respectively.

In terms of employment generation, SMEs provided a total of 3,532,935 jobs in 2010 or 62.3 percent of the total jobs generated by all types of business establishments. Large enterprises generated 2,136,362 jobs. Among SMEs, microenterprises created 1,729,100 (30.5%) jobs, while SMEs generated 1,417,672 (25%) and 386,163 (6.8%) jobs, respectively. SME employment by industry generally followed the same structure as the number of establishments per industry—with SMEs engaged in the wholesale and retail trade generating 1,237,917 jobs in 2010, followed by 617,634 jobs in manufacturing, and 479,668 jobs in hotels and restaurants.

In line with this, two main points are noteworthy. First, despite the fact that micro, small, and medium enterprises (MSMEs) contribute the majority of jobs recorded in the survey, these firms comprise roughly 99 percent of the total enterprises in the country. Hence, at the firm level, these enterprises do not generate as much employment as the larger firms. Second, the largest proportion of the jobs in the MSME sector is found in the wholesale/retail trade and repair services. These jobs are mainly of low quality, characterized by limited skills and low productivity.

Apart from employment generation, SMEs drive economic growth by: (1) stimulating innovation; (2) acting as competitors to existing businesses thereby helping to increase productivity; (3) and contributing largely to job creation.

In terms of stimulating innovation, the contribution of SMEs to innovation is seen to be important to the economy. However, in developing countries, researchers find that large exporting firms are typically the primary agents that bring new technologies to local communities. Thus, from a developing country perspective, this research evidence does not necessarily favor SME subsidization as a mechanism for boosting innovation and productivity growth. In the Philippines, Aldaba (2009) finds that the deepening of high-technology industries has remained weak due to limited backward linkages and low value added on high-technology export products.

SMEs stimulate competition that raises productivity, which, in turn, stimulates economic growth. The concept of 'creative

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destruction' is a widely recognized principle (Schumpeter 1942), whereby new innovative entrepreneurs challenge incumbent businesses. However, in the Philippines, while some notable improvements in the number of enterprises, value added, and employment were seen, the overall economic performance of SMEs in the last decade has remained weak (Aldaba and Aldaba 2014).

Research evidence shows that small firms make a disproportionately large contribution to job creation, given the percentage of the workforce they employ. However, although they employ a significant number of people (Tecson 2004), small firms were found to have a low contribution to employment growth. Moreover, when the economy is down, many small firms last relatively short—only three to five years. Most SMEs are presently in the 'at risk' or 'insulated' categories, and adapting to the increasing competitive pressure brought by open regionalism remains to be their biggest challenge.

There is no measurement of how many SMEs are actually poor. However, data show higher poverty incidence among the employed compared to those who are unemployed and self-employed. If the self-employed and unpaid workers include



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owners and employees of SMEs, it may be inferred, then, that a certain proportion of these SMEs are actually poor. This does not mean that SMEs are inefficient. Poor SMEs perform the same function as any other SME in the sense of creating value in the chain of productive businesses or reducing the transaction costs in production process. Furthermore, the lack of capital and financial support hinder SMEs to access better technology and quality inputs. Hence, direct interventions toward poverty reduction in the form of public goods are expected to support SMEs and to raise growth.

### **The conceptual role of SEs**

In the Philippines, SEs are linked to social entrepreneurship as a process of creating spaces and transforming markets to serve the goal of poverty reduction and sustainable development. An SE aims to increase “social value” and

contribute to the welfare or well-being of the community members. SEs are expected to influence the local conditions primarily in improving economic conditions. However, disagreement exists over the importance of social value in the purposes of the enterprise. In particular, the main issue is the value of creating wealth, which may be contrary to its social welfare goals.

Given its social orientation, SEs can be viewed as producing public goods accessible to all workers in a community. The publicness of the good produced by SEs indicates its potential for collective consumption. The goal is to achieve a more inclusive development by allowing the benefits, including greater employment for other businesses, to be accessible to everyone that is part of the enterprise, such as their consumers and other members of the community.

Providing the public with protection, opportunities, education, electricity, health benefits, and water, among others, used to be the responsibility of each government. But with the spread of privatization as a market mechanism, these services are, one by one, being provided by private businesses. The record of the past 25 years of market-led development, however, has not been encouraging. Not only has it failed to improve public services significantly, but it has also undermined democratic institutions and processes, reproduced authoritarian relations of power, and suppressed alternatives made possible by an increasing global acceptance of the importance of economic and social rights.

The development of the SE can be a solution to the failed provision of public goods. SEs operate in

markets to address social needs and reduce inequality, recognizing that this has value. In addition, the ability of an SE to create new innovations can be used to link their production activities to the global value chain (GVC). The developments of recent years have shown that, increasingly, firms are globalizing their production and value-creation process with the help of international suppliers. These collaborations between firms enable individual businesses to generate entrepreneurial growth and to create and expand competitive advantages (upgrading) and synergy effects. Transnational and situation- and cooperation-specific norms, which govern the conduct of value-chain actors, have also played significant roles.

### Empirical analysis

Using an integrated household production model, this paper tested key economic and social variables that affected the performance of MSMEs and SEs. The data used for this analysis came from a 2012–2013 baseline survey that was conducted by the Ateneo Center for Economic Research and Development for several of its partner NGOs. The objective of the survey was to collect baseline data for SEs in 13 projects being implemented by the NGOs. The sample consisted of control (beneficiaries) and treatment groups consisting of MSMEs and SEs, the latter being the industries being supported by the said NGOs.<sup>2</sup> These NGOs include one of the largest SEs in the country.

The objective of the empirical analysis is to identify key factors that are associated with revenues, incomes, and poverty. Data on labor employment are missing and, if ever these exist, seem to be affected by measurement errors. Hence, the dependent factors are used to

substitute for employment creation as labor demand is derived from the firm's profit maximization and its income status. Revenues, incomes, and poverty incidence are the key indicators of welfare and income that determine the potential of the firm to increase its scale of production.

Using the framework of coordinated household decisions presented in the previous section, these variables include: factors of production (loans and costs), household composition, household assets, water and hygiene, health, geographical factors, preferences, and unmeasured NGO characteristics.

The source of the loan, which can be an NGO, a microfinance institution, or a cooperative, is another factor included as a variable.<sup>3</sup> This is intended to control the loans that are used for production instead of consumption.

Using OLS and probit, the following results were significant for these variables used as determinants:

- **Loans:** Loans per se were not significant, but loans considered as production loans (coming from their NGO partners) are associated with higher incomes and revenues resulting in lower poverty.
- **Costs of production:** This variable is intended to measure the increasing scale of the enterprise operations. With increasing costs, the production inputs are expected to increase proportionately.

<sup>2</sup> For confidentiality reasons, the NGOs will be left unnamed.

<sup>3</sup> In certain cases, these three categories can overlap.

Because of this, “learning by doing” and knowledge spillovers are formed. Nevertheless, as the enterprise further increased its size, there were lesser incomes and revenues observed, leading to a greater chance of becoming poor. Hence, innovation is necessary if the scale of production is to be raised. Technology then should be further improved as the scale of production increases.

- **Schooling:** Households with more college education tend to have more incomes and revenues and a lower chance of being poor. Similarly, those with more high school education also tend to generate higher incomes and revenues, and are able to move out of poverty.
- **Age composition:** Households with younger people (between ages 6 and 20) tend to receive more incomes and revenues and lower poverty incidence. In addition, having older people seems to decrease the chance of being poor.
- **Amenities:** Having electricity is associated with higher incomes and revenues as the chance of being poor is decreased. The same effects are observed for households that have working phones and are close to roads that are passable throughout the whole year. Houses with stronger walls may be one of the inputs used in the business. The results here show the importance of public goods in terms of infrastructure.
- **Water and hygiene:** These variables are related to the health of every member of the family, and so may have effects on production. Households that have their own water piped or delivered in their houses are associated with greater revenues. Those with sealed toilets are correlated with

higher incomes and revenues and lower poverty incidence.

- **Health:** Accessibility and visits to medical practitioners and the public hospital seem to lead to more revenues and more incomes, respectively. Public hospital visits also result in lower poverty.
- **Other income:** Having an overseas Filipino worker in the family tends to result in higher incomes for the household. Likewise, having the wife make more decisions seems to draw in more incomes and revenues, suggest lower poverty incidence, and show greater self-assessment in the household’s financial condition.
- **Environmental and social conditions.** Households residing in Luzon and the Visayas seem to have lower incomes and revenues. This reflects more the quality of the NGOs.
- **Calamity:** Households affected by calamities in any geographic location have lower incomes and tend to be poor.

These results indicate the value of business environment in affecting the revenues and incomes of these enterprises. In addition to these, there are other factors such as education, amenities, and social conditions that may be considered. This emphasizes the importance of directly addressing poverty and providing public goods to these enterprises.

**The APEC policy on SMEs and SE**  
Government policies on SMEs can be classified in two ways, namely: (a) the promotion of development of local industries, and (b) the



enhancement of assistance in infrastructure building, technology transfer, SME promotion, and development of supporting industries designed to strengthen the national financial system, develop core human resources, and upgrade business management and technical skills.

What is missing is the aspect of public goods that helps reduce poverty directly within the SME sector and, in turn, be useful to the rest of the SEs in the community. As a result, public goods become global (sometimes called global public goods) in nature when the benefits flow to more than one country, and no country can effectively be denied access to those benefits. The promotion and protection of cultural diversity, core labor rights, and the environment through global cooperation are also regarded as global public goods. For instance, health was shown to have a significant effect on SEs. Hence, this can be an important input coming from the international community.

For the APEC member-countries, supporting SEs means supporting global public goods as SEs produce public goods for the communities. One of the key questions about global public goods is: How can investment be encouraged? Failure to provide global public goods is linked to collective action problems such as “free riding”. The term free rider describes a situation when no individual is prepared to pay the cost of something that others may be expected to benefit from; instead, all hope that someone else will pay for it, and they will benefit for free.

In supporting the SME sector, APEC foresees the formation of a GVC, which refers to a value chain that operates in more than one economy. GVCs

not only cover vertical links (among different tiers of suppliers along the chain) but also horizontal links (the interaction among suppliers of the same tier). Along the GVC, a major part of value creation is derived from product and process innovation, as well as in branding and marketing.

The GVC, however, is only as strong as its weakest link. While SEs can be developed as a valuable part of this value chain, they can also be a weakness because of the poverty constraints they face. In the weakest-link case, strong incentives exist for parties to cooperate and provide for the common defense (Hirschleifer 1983), resulting in little incentive (or the possibility of free riding). Weakest-link technologies, then, are ones where the noncooperative outcome closely approaches the efficient outcome only as long as countries have similar tastes and incomes. With weakest-link technologies, coordination and technological cooperation may be sufficient to produce reasonably efficient outcomes.

APEC can then help support SEs by linking them to GVCs. To do this, APEC countries can work together in providing the necessary global public goods that can help address poverty directly. These can be in the form of technical knowhow and infrastructure, including disaster relief and

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Meanwhile, NGOs, given their expertise and broad connection, can link these SEs and production units (household enterprises) into the GVC. If NGOs are able to provide the proper incentives for these firms, the global community will voluntarily provide the public goods to enhance its productivity and increase its scale of production. For NGOs, the following are ways that they can integrate their SEs into the GVC:

- Integrating with other SMEs
  - facilitating the entry into the market of new, dynamic players
  - strengthening business relations between SMEs and big companies
  - helping SMEs become fully integrated international business partners
  - streamlining business processes
  - increasing returns on investments in information and communication technologies
  - improving business transactions
  - reducing administrative overheads or errors
  
- Complementing the larger companies
  - increasing their innovation capacity by

partnering with other innovative established firms

- enhancing customer satisfaction through more flexible, personalized services
  - shortening time-to-market delivery
- Coordinating with the rest of economy and society
    - promoting a more dynamic and competitive economy
    - facilitating the market entry of new players, on fair terms. 📄

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