ENTREPRENEURIAL ILLIQUIDITY PREFERENCE
AND THE EXTENDED FAMILY

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ABSTRACT

It is postulated that the claims of the extended family on the African entrepreneur take the form of a tax on liquidity. Business practices puzzling to trained observers are explained in terms of the entrepreneur's need to ensure that his liquidity varies within narrow limits. It is argued that the African entrepreneur is a "maximizer" after all -- subject to social constraints. Small business advisory agencies are urged to reexamine their standard remedies for frequently recurring problems of the African entrepreneur to ensure that they take into account an understandable reluctance on his part to permit his liquidity to rise and fall to whatever levels may be required for unconstrained profit maximization.

Observers from Western countries are often baffled by what they regard as irrational behavior on the part of African entrepreneurs, and often conclude that what is required is a demonstration of the application of profit-oriented decision-making to the entrepreneur's circumstances. Hopefully the seemingly irrational behavior will then disappear. The following quotations are illustrative:

> There is a tendency for small-scale rural enterprise to be over-capitalized. This seems paradoxical in the light of the usual view that there is a capital shortage. Our observations at the firm level suggest that the contrary is often true; the capital shortage of at least some firms could be substantially reduced by more economical use of the capital at hand.
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> Casual observation suggested, and our data tended to confirm, that some firms kept excessive stocks of raw materials on hand. Stocks equal to several months' use at current rates of output were fairly common; several firms held stocks in excess of annual sales. One extreme example is the case of a firm offering repair service whose spares on hand, assuming they were of the composition required for future use, would fill the firm's need for 4 years. This is a heavy investment for a small enterprise; not only is scarce capital tied up in excessive stocks, deterioration or spoilage must be substantial. (1, p. 5)
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> Investment in equipment is frequently excessive or mis-directed and examples are more easily identified. We were puzzled by the owners' high estimates of excess capacity....but after numerous visits and observations came to believe that for some productive capacity or simply capital equipment was a matter of personal pride and that there was a remarkable amount of little-used or even idle equipment among the firms in our sample. Some equipment was totally inappropriate to the firms' business. Included, for example, were an unused welding unit owned by a wood-working firm, power equipment owned by firms with no power, modern equipment owned by firms which lacked trained workers capable of using it. Examples of the latter included diagnostic equipment for an automobile repair firm and a universal woodworking machine which was used for only a limited range of possible tasks....
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> We positively identified 16 cases of large, expensive capital equipment inspprepriate to the firm's activities and hence completely idle... Discussing this topic, some owners would observe that they had made a mistaken purchase. Others offered that they had "waited a long time to buy the machine," that

> it was too good a buy to pass up -- all indicating motives other than rational, profit-seeking investment. We concluded that, for some businessmen, acquisition of capital equipment is identified as a "routine" business activity and that ownership is a symbol of a successful business rather than an investment which must yield a return sufficient to justify its existence. (1, p. 7)

Harper reached similar conclusions in a study of 150 rural shopkeepers:

> Many people may by now have come to believe that the major problem for rural businessmen really is lack of finance. Enquiries among a number of rural businessmen certainly indicate that most of them are quite sure that it is their major or in fact, their only problem. It is natural to mention to an outside enquirer only the problems which you think he may be able to solve, but the respondents are quite sincere in their opinion. Very few of these traders have any security for a loan, and the supply of funds available to lenders who will accept risks of this sort is inevitably far less than the demand. It is unusual for more than a quarter of applicants for locally administered loans to be successful. It is likely that most rural businessmen will feel disappointed and frustrated because they are unable to get the loans that they have come to believe are essential for success. It is very difficult to convince such businessmen that loans are not a panacea, and there is some evidence to show that they judge each others success not by profits, volume of sales or apparent size of the business but by whether they have been able to obtain loans or not. Far from being one of many tools to assist the business, loans from Government have come to be regarded as an end in themselves. Traders are suspicious of anyone telling them that loans are not the only things that matter, because they regard such an effort as a cover up for the inadequacy of the funds which are available.....
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> About 75% of the shopkeepers believed that they needed outside finance to improve their businesses and at the same time had enough money in the business, in the form of slow moving stocks, or could retain enough money from profits in less than twelve months, to pay for what they wanted without recourse to outside sources. All of them were aware that commercial bank finance was most unlikely to be available to them, and they also know that it might take several months to process their application for a Government loan. Such was their preoccupation with loans that they nevertheless pinned all their hopes on them, and did not consider any other solutions which might be quicker, cheaper and more certain of success. (2, pp. 2, 3, 7)

In short, the African entrepreneur uses his capital most inefficiently, and then consumes time and money to come to Nairobi to seek further capital in the form of a government loan.

This is indeed puzzling to a Western observer. The following analogy is intended to bring the problem into sharper focus. Suppose that a "man from Mars" had observed the behavior of American urban motorists at the time of the oil embargo. He would have seen enormous wasteage of mechanical energy during traffic jams. Having watched a vehicle negotiate a traffic jam, he would then find it joining a long queue at a petrol station, wastefully expending energy while inching toward the head of the queue. The "man from Mars" would likely conclude that American urban motorists should be shown the error of their ways, and be taught the optimum driving conditions for efficient energy use; unless he happened to realize that the problem was the lack of an inexpensive, compact, efficient means of storing mechanical energy (perhaps an improved flywheel).

The entrepreneurial behavior described by Child and Harper can similarly be explained as a lack of an efficient means of storing not mechanical energy, but liquidity. Physically, there is of course no problem of storing liquidity. In the context of the African-style extended family, where nuclear families (the effective household decision-making unit) are linked with relatives by a complex network of rights and obligations involving significant transfer of funds, it can be postulated that the obligations imposed on the entrepreneur by the extended family take the form of a tax on his liquidity: if the entrepreneur states truthfully that his assets are tied up, he will ultimately pay less toward relatives' school fees, land acquisition costs, etc. Transfers of income by African residents of Nairobi were estimated by Whitelaw to comprise 23% of their total income. (4)

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1. A different form of extended family prevails on the Indian sub-continent. Several generations live under one roof. All income passes into the hands of the family head for subsequent disbursement. This paper is not concerned with the latter form of extended family.

Keynes viewed interest as a reward for parting with liquidity. Here we have a situation where there is a positive desire to shed liquidity. The three motives which Keynes postulated would give rise to liquidity preference are discussed in this new context:

(a) Precautionary Motive. The extended family assumes many of the functions which in Western countries have been taken over by the welfare state. Unemployment in Western countries is looked after by some form of unemployment insurance. In African countries a person who finds himself unemployed turns to his relatives for support. The rate of failure among small entrepreneurs everywhere is high. Because of the ability to turn to the extended family for assistance in times of crisis, it is conjectured that the precautionary motive is less important in African than in Western societies. Because of its role in emergency situations, however, the African entrepreneur needs the extended family. He does not, despite his endeavours to limit the extent of his support, seek to destroy it. He merely, in insurance jargon, wishes to ensure that the premiums bear a reasonable relationship to the face value of the policy.

(b) Transactions Motive. This is no different from standard Keynesian analysis. It serves to ensure that the entrepreneur will not want to become totally illiquid.

(c) Speculative Motive. There does not seem to be an *a priori* basis for comparing the magnitudes of this motive in African and Western societies. It will be argued below that this motive is inoperative if the minimum cost of making a speculative purchase is either conveniently low or so high as to present virtually insurmountable barriers; in the former case the entrepreneur will tend to buy more (or more often) than the speculative motive might warrant, in order to shed liquidity. The speculative motive, in normal economic circumstances, comes into play primarily when the transaction size is difficult but not impossible to digest.

Operating in the opposite direction is the desire to avoid the liquidity tax imposed by the extended family.

Funds reach the small-scale entrepreneur in very small amounts. The effect of the foregoing considerations is to motivate the entrepreneur to conduct his business affairs in such a way as to ensure that liquidity varies within narrow limits. He therefore tends to favour business outlays which involve small amounts of cash. Large capital outlays would require a gradual build-up of liquidity, which would be subject to the claims of the extended family. Large capital outlays financed by a government loan, on the other hand, involve no corresponding hemorrhage. The repayments, on the other hand, are less chunky, and therefore wreak less havoc with his attempts to smooth out variations in liquidity. Similarly, investment in inventories can serve as a balancing item in avoiding over-liquidity. This serves to account for the phenomenon or bias toward investment in inventories, whose existence cannot be doubted. Child writes:

> One businessman we interviewed was devoting the excess of sales revenue over out-of-pocket expenses plus living costs -- his net cash flow -- to a rapid and virtually unlimited accumulation of stocks; he simultaneously complained about his inability to raise funds for purchase of modern equipment. (1, p. 10)

In view of the foregoing analysis, is it surprising that the notion of varying stocks (and hence liquidity) at will in pursuit of maximum profits might seem odd to an African entrepreneur?

> Discussion with owners revealed that purchase of stocks was sometimes considered a priority outlet for available funds: purchase of stock is a "normal" business function and large stocks on hand is an outward sign of success. The notion that raw material stocks should be at a minimum level consistent with an orderly flow of production was often received with puzzlement. The concept of "optimum" stocks was unfamiliar -- even though some, by their very behavior, indicated an appreciation for it. (1, p. 6)

It is known that financial management of a highly seasonal business in Western countries requires substantial seasonal variations in working capital. The African entrepreneur, striving to rein in his liquidity, might not prove equal to the task.

> Consumer goods sales in rural Kenya follow a seasonal pattern. They are high after harvests or during the period when marketing cooperatives disburse funds; they are low during the growing seasons or when there are other claims against the

> households' limited funds, e.g., when school fees must be paid. Seventy-six out of 87 firms in our sample reported that their sales fluctuated seasonally, a view confirmed by entrepreneurs not included in our detailed study. Since knowledge of seasonal variation is widespread,; it is a bit puzzling to hear complaints about sales lost due to lack of funds for wages or raw materials during the slack season.
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> In a capital-scarce society it is understandable that firms find it difficult or too costly to hold precautionary money balances to meet unexpected interruptions of income or unexpected expenditures. Failure to provide working capital for anticipated or recurring fluctuations in sales is more curious. Some entrepreneurs not only did not cope with a recurring pattern of sales variation, they allowed their firm's working capital to be depleted by personal outlays which might easily have been anticipated, e.g., payment of school fees and purchase of school uniforms for their own children. (1, p. 12)

Overstocking by African entrepreneurs is a phenomenon which can only be appreciated in quantitative terms. The figures in the Table on the following page are taken from Harper. (2, pp. 5, 6 and 7) Group 1, comprising approximately 70% of the shopkeepers, is a category of established, successful enterprises. Group 2, comprising 20% of the shopkeepers, is a category of more recently established endeavors. It is noteworthy that the former had on average more than eight times the value of stocks of the latter, while enjoying double the latter's monthly sales. This phenomenon cannot be attributed to a tendency to add slow-moving, high-mark-up items as capital becomes available for increasing stocks, because the ratio of cost of goods sold to sales is approximately the same in both cases.[2] Clearly investment in stocks is subject to diminishing returns.

Child considered the possibility that accumulation of stocks could be a hedge against inflation, but rejected it on the ground that inflation was rarely mentioned by respondents. (1, p. 5) In addition, construing the accumulation of stocks as a hedge against inflation would amount to crediting the small entrepreneur with better foresight

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2. The ratio of cost of goods sold to sales works out to 0.75 for Group 1 and 0.71 for Group 2; the hypothesis of a shift to low-volume, high-mark-up goods as stocks increase should produce the opposite order. Moreover, the value of stocks for Group 3 (comprising about 10% of the shopkeepers) was on average only one twenty - fifth of the Group 1 figure; the ratio of cost of goods sold to sales for Group 3 was 0.73.

	Group 1	Group 2	Group 3
ASSETS			
Cash	Shs 170/-	Shs 120/-	Shs 30/-
Bank Balance	Shs -	Shs -	Shs -
Owed by Customers	Shs 200/-	200/-	Shs 250/-
Stocks	Shs 500/-	Shs 300/-	Shs 100/-
Equipment	Shs 210/-	Shs 200/-	Shs 90/-
TOTAL	Shs3080/-	Shs 820/-	Shs 470/-
EQUITIES			
Owed to Suppliers	Shs -	Shs -	Shs -
Loans Outstanding	Shs	Shs	Shs -
Loans Outstanding	Shs -	Shs	Shs -
Owner's Original Investment	Shs 500/-	Shs 400/-	Shs 500/-
Reinvested Profits	Shs 2580/-	Shs 420/-	(Shs 30/-)
TOTAL	Shs 3080/-	Shs 820/-	Shs 470/-

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	Group 1	Group 2	Group 3
Sales per month	Shs 1200/-	Shs 600/-	Shs 550/-
Less: Cost of Goods Sold	(Shs 900/-)	(Shs 425/-)	(Shs 400/-)
Markup or Gross Margin	Shs 300/-	Shs 175/-	Shs 150/-
Less: Owner's wages, drawings in cash or kind	(Shs 50/-)	(Shs 65/-)	(Shs 80/-)
Less: Tent, licence fees, GP Tax, all other expenses	(Shs 75/-)	(Shs 45/-)	(Shs 75/-)
NET PROFIT (LOSS)	Shs 165/-	Shs 65/-	(Shs 5/-)

N.B. These figures are characterized by Harper as an "typical set of accounts for each group," and should not be construed as exact sample means. Experienced, successful shopkeepers fall into Group 1; newer entrants fall into Group 2; and failing enterprises fall into Group 3.

than large firms in anticipating the recent increase in the rate of inflation. Until fairly recently, Kenya had one of the lowest rates of inflation in the world. Child felt that a more plausible explanation would be "periodic shortages, a frequent and seemingly random or haphazard phenomenon of the Kenya distribution system." (1, p.5) While this unquestionably is a problem, the phenomenon is no more prevalent than in other developing countries; and in any event Harper's figures indicate that the returns from accumulation of surplus inventory are not commensurate with the capital requirements -- the problem is not worth solving.

It is noteworthy that Group 3, which had the lowest asset value of the three groups, nevertheless had the highest amount owed by customers. This illustrates the importance of credit management as a determinant of success. Amounts owed by customers were equivalent to 0.7 weeks sales, 1.4 weeks sales and 4.0 weeks' sales for Groups 1, 2 and 3 respectively.

Marris and Somerset concluded that consumer credit was less prevalent in rural Kenya than in developed countries; nevertheless bad debt losses accounted for many business failures:

> Apart from the fear that prosecution will lose the goodwill of the community, the other reasons against pursuing debts are probably as persuasive in the most sophisticated economies, where the extension of credit is more liberal, and the rate of default as high. (3, p. 155)

They went on to show how the absence of social pressure to pay one's debts, particularly when one's creditor is a relative, has led entrepreneurs to accentuate the separation between business and household affairs. The following quotations from three of their respondents illustrate the forces at work:

> If they come for shoe repairs, even if it is only fifty cents, they must pay. But if they come for a cup of tea, I'll take them out to tea and treat them. Originally people didn't understand about business, and expected things free. Some businesses failed because of this. But when the business fails people laugh at you. Nowadays people know that business is business.

> That's a big fight. In this part of the country, relatives very much intend that things should be given free. So we just have to dodge them out of the way. I always tell them, if you want any free

> thing you should come to my home. This is a business place, not a place where things are given free.
>
> They want their clothes cleaned free. I tell them the machine is to be paid, the workers are to be paid. They complain and hate me, but I don't mind. When our father died he gave land to each of us, and since then we have been independent, and gone our own ways. (3, p. 157-58)

It is possible to to interpret the foregoing as a repudiation of the entrepreneur's ties with his extended family. Yet the entrepreneur continues to provide assistance to his kin. It seems more likely that the entrepreneur is trying to prevent the extended family from taking goods off his shelves, just as a peasant farmer would prevent a relative from taking away the seeds required for the following planting season. Marris and Somerset argue as follows:

> Thus the businessmen tried to deflect the obligation of kinship from the business to themselves, segregating it as a system of economic relationships governed by its own rules, where family loyalties had no right to intrude. Often, by agreeing to discuss requests only at home, away from their office, they underlined the distinction between their personal income and the assets of the business, drawing a physical boundary between their commercial and their family role.... Especially if the businessman paid himself only a modest salary from the enterprise, he forced his family to appeal to himself, not to a row of well stocked shelves, and insulated the business from claims he could not personally ignore. (3, p. 158)

The intuitively obvious solution to the entrepreneur's dilemma is to put his money in the bank. His relatives need not even know that he has an account. Why not?

Various studies of household behavior among the poor in the United States have revealed a pattern among households with low and unsteady incomes on receiving pay of two weeks of meat, one week of beans and then one week of soup. The poor have no status to protect; they have no qualms about cadging from each other. The low-income householder can anticipate that one or more of his neighbours will come to him in desperation over the next month with a plea for money to cope with some emergency. He would find it very difficult to refuse: next month he may be in a similar situation himself. It does not, however, take a hard heart and an iron will to anticipate such a situation, and to spend as much of his money as possible while there are no claims against it. One would expect this sort of behavior to be even stronger among African entrepreneurs and salaried employees as the practice of looking to the extended family for help in times of trouble is so firmly institutionalized.

One widespread practice among medium - and high-income African civil servants in Kenya and Tanzania is to purchase a month's supply of non-perishable food and related items immediately on receipt of one's monthly salary. This practice is, in the writer's experience, common among the financially astute. A colleague in the Ministry of Finance and Planning was asked why he followed this practice. He replied, "My family must come first." He went on to explain that if some of his relatives had a crisis part way through the month he might be persuaded, in the circumstances, to skimp on providing for his family for the remainder of the month in order to provide adequate assistance to his relatives. By ensuring on payday that the needs of his family are met first, he avoids a possible traumatic value conflict later on. Such a value conflict could not be avoided by putting money in the bank. It can be expected that the extended family would forever be concocting new rationalizations for demanding an increased level of support from the entrepreneur, the cash register being so visible. Tying up one's assets in illiquid form is one alternative to meeting the problem head-on. The African entrepreneur finds that illiquid assets are a more effective means of storing wealth than those which can readily be converted into cash.

The salaried civil servant and the entrepreneur share a desire to shed excess liquidity. The former, however, receives his income on a monthly basis in a fairly large chunk. In order to keep his liquidity within narrow limits he seeks a means of ensuring that his disbursements are concentrated in a short period following receipt of his monthly salary. Purchase of durable goods on monthly instalments is one way to achieve such a disbursement pattern. Africans on low monthly salaries who are unable to purchase consumer durables on credit will often adopt a different practice: they will offer a down payment and make monthly instalments while the goods remain in the seller's possession. When the full purchase price has been paid the bargain is fulfilled and the purchaser takes possession of the goods.

Higher-income salaried Africans favour the purchase of real estate and expensive automobiles (relative to their incomes) on credit, as such arrangements facilitate the desired pattern of disbursements. As their salaries are public knowledge they have no reason to pretend to be poor. It is acknowledged that the African entrepreneur lives very frugally, avoiding anything smacking of conspicuous consumption.

One custom common to East and West Africa, seems designed to circumvent the problem of indivisibility of capital goods and the attendant need to accumulate the cash necessary for the purchase price over time. Perhaps ten people (not necessarily blood relatives) form a pool into which each contributes, say, Shs 100/- monthly. One of their number walks of with the entire collection of Shs. 1,000/-. Complications arise when somebody moves or finds himself temporarily unable to keep up his contributions. It is difficult to imagine such a custom taking root in a Western country, as there is no perceptible benefit and a not inconsiderable organizational problem. For the African participant, however, it fulfills a major need. He can, sooner or later, acquire Shs. 1,000/- of cash without ever having had to slowly accumulate a cash balance greater than Shs. 100/-.

The notion of illiquidity preference was anticipated by Harper, who put greater emphasis on excess stocks as a status symbol:

> Well stocked shelves and a full store room, regardless of the saleability of the items in stock, are a clear sign to the owner himself, and perhaps more importantly to his friends, that his business is prosperous. Such a businessman, not unreasonably, takes pride in his success in building up the value of his business from Shs. 560/- to Shs. 3,080/- in two or three years. There may be some logic in judging the success of a business by the growth of its stocks. A competitor who has bought more wisely and achieved higher profits may at the same time have been able to draw more money out of his business and spend it on school fees, subsidies for his family's farming activities and so on. At the end of the day he will have less to show for his efforts in business than the man who has built up large stocks of slow selling goods. Visible display of wealth is surely one of the goals of most businessmen, and the extended family system effectively prevents a man from making such a display with personal possessions. Perhaps an over-stocked shop is a reasonable substitute for new clothes, better housing or a car. (2, p. 5)

A motorist who values his automobile as a status symbol is likely to have it washed and polished frequently. To the extent that an entrepreneur values his premises and stocks as status symbols, one might expect a similar display of "tender loving care." Child reports:

> Our African businessman shows a high tolerance for disorder. A first-time visitor from a highly developed economy is often appalled at the disarray so visible around the premises of African enterprise. Stocks are piled in unprotected disorder, subject to unnecessarily high wasteage. Handtools not in current use are, seemingly, pushed aside and left subject to damage or deterioration rather than carefully stored. Machinery is often over-used and under-maintained; damage and depreciation rates must be high. Various productive activities are haphazardly arranged and crowded to the point of mutual interference. (1, p. 9)

That African entrepreneurs might take pride in their inventories is not disputed. It seems unlikely, however, that status-seeking is the prime motivation behind the accumulation of stocks.

Since the obligations of the extended family are postulated to take the form of a liquidity tax imposed on both the entrepreneur and the salaried employee, one would expect household behavior similar to that encountered in hyperinflations -- hyperinflation is another form of liquidity tax. A formal, state-imposed tax on liquidity has beed advocated for Muslim states as an alternative to permitting interest (contrary to the dictates of the Quran) which, in the Keynesian view, is a reward for parting with liquidity. No Muslim state seems to have adopted this proposal. For those who would seek some empirical assessment of the workings of a liquidity tax, the various studies of entrepreneurial behavior in African countries are commended.

The hypothesis that the entended family imposes a liquidity tax upon the African entrepreneur has been tested against the evidence, and has been found to be consistent with such empirical findings as have come to the writer's attention -- comparing favourably with alternative hypotheses put forth by the investigators themselves. Unlike much of the work in economic anthropology, the hypothesis of entrepreneurial illiquidity preference seems to hold out the possibility of aggregation, so that its public finance implications can be assessed.

It is proposed that small business advisory services in Kenya and other African countries reassess their standard remedies to recurring problems facing the small businessman, and to ensure that they take into consideration his need to minimize fluctuations in the size of his liquid assets.

One suggestion by Harper fits in well with the postulated phenomenon of illiquidity preference:

> These stocks cannot be sold quickly at the normal prices.... They can be sold off at low prices, which rarely need to be below the original cost. It may be difficult to show shopkeepers in this group that these goods can and should be sold off, even at a loss, but if the reward for such disposal is the equivalent of the much desired loan there may be some hope. (2, p. 5)

It is not customary for merchants in rural market places to hold sales from time to time. A sale to sell off slow-moving goods does seem to have much to commend it. It is not, however, clear whether a demonstration of the ability of inventories to be quickly converted into cash will create a situation where the merchant is urged to hold a sale in order to acquire cash to support the extended family. An actual test seems to be required.

Other possibilities present themselves. An enterprising distributor of capital goods, many of whose customers are African entrepreneurs (a distributor of tools, perhaps), might assist the enterepreneur to hurdle the barrier of high single cash outlay by accepting surplus stock as part payment. Disposal of such stock in smaller urban areas should not be difficult.

It is to be hoped that the foregoing analysis will lead to the generation of a number of novel solutions to the African entrepreneur's dilemma.

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