

**Background Note**

# **The Enterprise Sector: Providing Employment and Sharing Risk**

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## Background Note for World Development Report 2014:

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## 1. Introduction

In this background note the links between enterprises in poor countries, risk and employment outcomes are outlined. The focus of the WDR is on how risk can best be managed and how the benefits of both formality and flexibility can be combined to ensure that the effects of risk are mitigated for both firms and households.

The aspect of formality on which we will mainly focus is the size of the enterprise. While this is only one aspect of what is defined as comprising formality it is arguably the most important in poor countries. Formality is usually defined to include being registered with the government, being taxed and subject to a range of labour force regulations. While there are some enterprises, particularly in the areas of self-employment, which are relatively large in terms of employment and are not formal in the sense of being registered and subject to tax these are exceptional.

The association of formality with labour market regulations is often taken to mean that as firms become more formal they become less flexible at least with regard to their ability to hire and fire labour. However firms change in many dimensions as they grow in size and there are a range of dimension in which they may become more flexible. These include the range of skills they employ, the number of produce lines they can supply and their access to technology that enables them to produce goods of higher quality.

In this note we will view flexibility as the ability to respond to shocks which an enterprise may face in a manner that enables productive enterprises to survive and prosper. While the failure of an enterprise clearly has costs for both its owners and its employees, and such failure is one of the risks which may deter the initial investment, the failure of less productive enterprise is a key part of the process of successful growth.

Flexibility thus has two components one located in attributes of the firm and the second located in the attributes of how successfully the market can enable more productive firms to grow and for labour to be reallocated across those firms. More formal enterprises may have attributes which enable them to respond to changing market circumstances thus ensuring more flexibility. A flexible market structure is thus one where shocks lead to a process of growth among the relatively productive. Such flexibility will then act to promote formality as the more productive firms expand and become more important players in the market.

These links between formality and flexibility will be explored in the next three sections. The note is structured by looking at enterprises by locality and size in the next Section and then looking at the incomes from enterprises in Section 3. Across both sections we link enterprises and incomes to the question of how risks can be managed. In Section 4 we link the themes of formality and flexibility to broad areas where policies can affect the outcomes by managing risk.

## **2 Enterprise Type and Risk Management**

### **2.1 Rural and urban based enterprises: How does the locality of the enterprise impact on its ability to manage risk?**

In China rural based enterprises have been an important aspect of the rapid growth of that economy. In contrast the slower growing economy of India has seen no such boom while in SSA rural enterprises have not provided any basis for the growth of the economy. In SSA rural based enterprises have significantly lower productivity than urban ones suggesting that higher incomes are available in urban areas. Thus while locality affects many dimensions of the risks enterprises face there have been a wide range of outcomes across developing countries as to the success of rural enterprises which differ from urban ones in a range of dimensions relevant for the impact of risk.

How does the locality of the enterprise impact on its ability to manage risk? Risks will differ by the range of products the enterprise produces, the nature of the markets for labour, land and capital it faces and the ability of the enterprise to access international markets. As the work in the new economic geography has shown locality can matter. Locality can also be chosen so in assessing both the risks enterprises face and how those risks can be managed the reasons for the different outcomes for rural and urban enterprises need to be understood.

Rural based enterprises that depend on the local market to sell their produce will be linked to the success of that hinterland which will be dependent on agricultural markets. Thus shocks to such markets will get translated into demand for the rural enterprise. An illustration of this potential linkage is given in Lanjouw and Lanjouw (2001, p.11) “Of course, to the extent that the non-farm sector depends on demand derived from local agricultural incomes, it will covary and will only effectively smooth idiosyncratic risk. For example, the North Arcot district of Tamil Nadu suffered a severe drought in 1982/1983 with a fall in over 10% from normal rice yields. Non-farm business income also plummeted as a result. For non-agricultural households in the surveyed villages, average non-farm business earnings were 493 (1973/1974) rupees) in 1973/1974, fell to 19 rupees in 1982/1983 and rebounded to 1094 by the following year (Hazell et al., 1991). Clearly in this case non-farm income was very sensitive to levels of agricultural income.”

While the outcomes for rural based enterprise may be based on local demand this is not necessarily the case as the remarkable growth of the township and village enterprises (TVE) in China very clearly shows that not only that growth need not be confined to larger urban centres but that rural based enterprises need not be simply dependent on local markets:

“During the last two decades, China has pursued rural industrialisation at an unprecedented speed through the development of the TVEs. Although other economies, such as Taiwan’s, took similar roads to rural industrialisation, TVEs in China have no equal elsewhere in their unprecedented growth rate and magnitude. Official statistics indicate that from 1978 to 1994, the average annual growth rate of rural industrial output was about 27%, almost three times the growth rate of national GDP. Rural industry surpassed agriculture in size in 1987 and

now comprises half of the total Chinese economy. From 1986 to 1998, the average asset scale of TVEs increased tenfold and the average scale annual growth rate is about 21%” Zou (2003, p.2)

These contrasting patterns illustrate how risks facing enterprise may differ depending on their linkages to local or more distant markets. It is not, of course, that access to markets beyond the local region removes risk but it changes its nature. If policy can ensure the rapid growth of non-farm activity – through either its greater use of more productive capital or its access to more rapidly growing markets – then risk reduction combined with rising incomes can result. With rising incomes and with the changing enterprise structure that accompanies such increases the nature of the risk management issues change. The basic shift is from managing risk to labour incomes where those incomes are very low to managing the risk associated with capital and its accumulation.

Risk across these two dimensions may be linked. If the problems of managing risk for investment cannot be solved then processes of rapid growth may not be possible. Again the Chinese TVEs present an example where the problems posed by risk and access to capital for relatively small scale enterprises were dramatically solved. However that success has not proved possible in either SSA or India.

We thus have a dichotomy in which rapid growth in rural based employment has proved possible while in other areas the poverty of income earning opportunities in rural areas has encouraged a view that migration from rural to urban areas is the only route to increases in income.

## **2.2 Non-farm employment: implications for risk**

The focus in 2.1 was on how their product markets influence both the ability of rural enterprises to grow and the risks related to those markets. Risks from product markets get translated into risk for the markets for labour, land and capital. In this sub-section we switch attention from the enterprise to its employees and their households. The risks rural households face depends essentially on the incomes available from rural employment and their predictability. Again the major contrast is between the experience of China and that in SSA and South Asia. China has seen both a far more rapid growth in rural labour non-farm employment and a greater switch from rural to urban employment than has occurred in either SSA or South Asia.

In the context of the poorest countries in SSA and India the focus has been on how far non-farm sources of income can stabilise household incomes. The review paper by Lanjouw and Lanjouw (2001, p.11) shows that, in contrast to the illustration used above this can occur. “Reardon et al. (1992) reports that for three regions in Burkina Faso, the ratio of the coefficient of variation of total income to the coefficient of variation of cropping income was 0.61, 0.76 and 0.69, indicating that total income was considerably more stable than cropping income alone (see also Reardon and Taylor, 1996). Similarly, Lanjouw and Stern (1998)

show that in the north Indian village of Palanpur, the expansion of non-agricultural employment opportunities has accompanied a fall in the degree to which household incomes in the village covary.”

These examples are concerned with how incomes may be stabilised through non-farm employment. While such stabilisation is a major part of risk management it needs to be seen as a minimal objective of policy. If non-farm employment can be made the source of growing incomes then the risk management issues can shift from a concern with survival to a concern with how to manage risk with growing incomes. Without such growth the survival objective dominates and clearly remains a vital part of risk management.

What are these aspects of risk management for economies where non-farm employment is not growing? How far shocks get translated into the markets for labour and land will depend on a range of factors to do with the structure of the enterprise. Insofar as these enterprises are dependent on household labour - as in the case in many of the poorest countries - such shocks will get translated into household income by lowered levels of labour input in the household. Insofar as a local labour market exists the risks will translate into non-farm labour incomes.

The impact of risks will depend on the structure of the local labour market. In some SSA countries local wage labour markets are very limited and rural incomes depend primarily on returns to land. Thus risks which impact on rural enterprises through the agricultural product market may well have a major impact on rural household incomes through both returns to labour (which may be implicit in the case of household labour) and the returns from land.

These impacts may differ for urban enterprises for several reasons. One is that the income base for consumers of the product may be more diversified. A second is that there may be more diversity of product demand within urban areas given the higher levels of income. If producers can shift across sectors or change products within sectors then risks can be diminished. A third is that technology choice may be greater within urban areas as inputs markets are more diversified. A fourth is that urban based enterprises may have lower cost access to export markets than rural ones. It is this final dimension of the structure of demand that is the most important for understanding the diversity of experience of both rural and urban enterprises.

Both the speed of growth and the relative rates of productivity growth between rural and urban areas have important implications as to how enterprises can manage risk. Two aspects of the Chinese experience are of importance for understanding the links between enterprise, locality and risk. The first is that the experience contradicts the notion that urban sectors necessarily can outperform rural ones as a source of employment and output growth. The second is that the problems posed by risk management need to be linked to the speed with which enterprises are growing.

Clearly a shock to an enterprise growing at over 20 per cent is very different from a shock to one not growing. Thus a strategy for growth is a strategy for risk management in that the

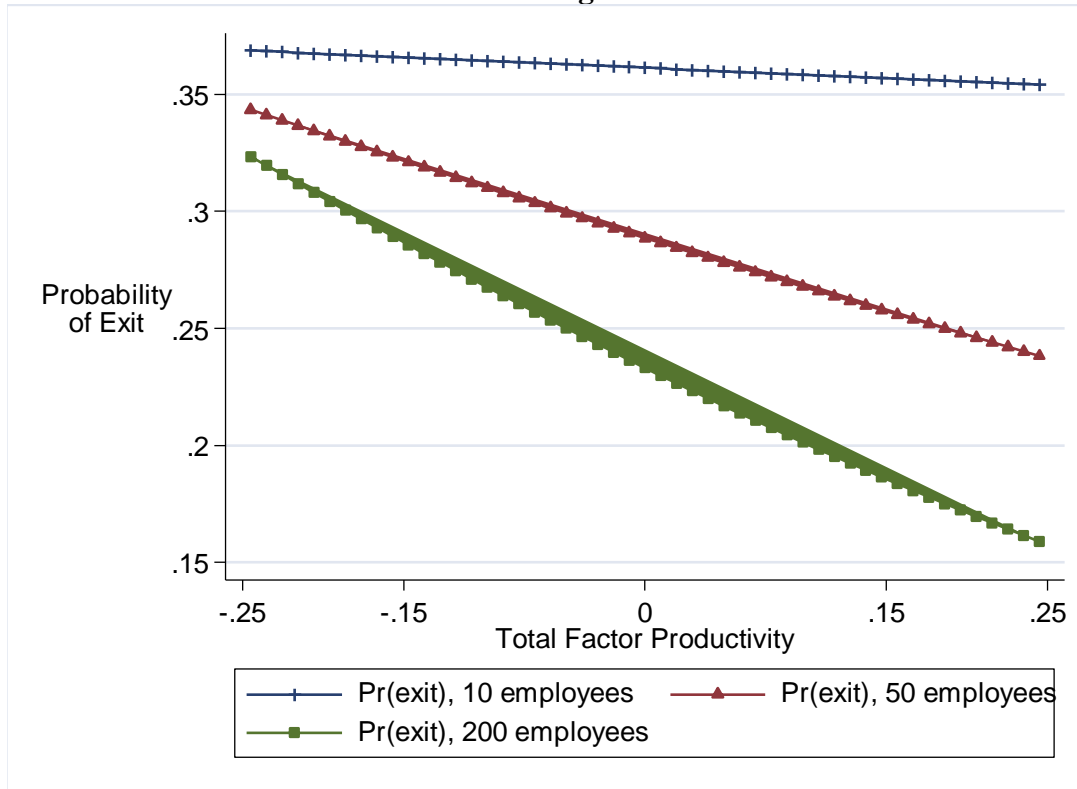
consequences of adverse shocks are less severe and there is a greater margin to absorb any shock. Rapid growth has other implications for how risk affects an enterprise. As scale increases the relative proportions of labour and capital may alter if, as much evidence indicates, returns to capital are far higher in smaller scale enterprises. Thus with increases in scale some of any shock to output will be absorbed by capital, in terms both of its return and in terms of underutilised capacity, as well as by labour.

### **2.3 Enterprise productivity, size and risk**

Productivity levels have important implications both directly for the ability of enterprises to manage risk and indirectly through their impact on the ability of enterprises to grow. In SSA there is evidence that the productivity of rural enterprises is significantly lower than those in urban areas. It may be harder for rural enterprises to survive when they face an adverse shock. For urban sectors there is evidence that the survival of some firms does depend on their productivity, Söderbom, Teal and Harding (2006).

Reforms in many African economies of their trading and exchange rate regimes in the 1990s eliminated much of the protection which previously limited competition. Söderbom, Teal and Harding (2006) focus on the role of total factor productivity (TFP) in determining whether or not firms can survive in the subsequent period. They use a pooled panel data set of firms in Ghana, Kenya and Tanzania that spans a period of five years. Their key finding (shown in Figure 1) is that productivity impacts on subsequent firm survival among large, but not small, firms. This result suggests that not only may small firms face higher risks but that there is no process of sorting by which the more efficient of them survive and grow.

**Figure 1**



Further work on both farms and small scale enterprises has shown extremely high rates of return on investment in poor countries. One possibility that may explain this outcome is the links between the lack of functioning financial markets and risk. Small firms do not have access to low cost finance so the high returns that have been observed reflect in part this lack of access to capital and in part, as the above figure illustrates, that such firms are high risk. In other words even with better functioning finance markets such firms would still face high capital costs.

In farms the links between risk, size and efficiency are complex. A key to incomes in rural areas is farm productivity. One area where the impact on poverty is potentially the most immediate is in investment that raises productivity in small-holder agriculture. However while small size may be associated with poverty it is also the case that small scale enterprise including farms may face high risks. They may also face high costs for inputs if they cannot benefit from scale economies.



### **3 Sources of Incomes and Risk**

#### **3.1 Farm self-employment and urban wage employment: how do risks differ?**

While the sectoral share of agriculture in GDP has been falling in nearly all countries in most poor countries agriculture remains by far the most important source of employment. The risks faced by those in rural based activities will depend on their access to land and to off-farm wage employment as discussed in the last section. The risks will relate in part to the returns from labour and land which may fluctuate due to weather and factors affecting demand for agricultural products and in part due to access to land and non-farm labour market opportunities.

One important divide here is between access of off-farm market employment and employment within the household. Much of self-employment may be unpaid family labour which will play a role in mitigating risk – its price can be readily changed – but the low returns to such labour may be a major source of low incomes and poverty within the household. Shifts, or the lack of them, in employment opportunities for households in rural areas have important implications for how these risks will change over time. If labour supply grows faster than market job opportunities than residual employment activities, which includes household labour, may increase in importance.

If much labour is concentrated in very low productivity activities the issue arises as to what limits its ability to transfer to higher income areas. It is the divide between rural self-employment and urban wage employment which has been the focus of much discussion in development policy. If, for a wide range of reasons, there are significant barriers to migration then such differences in income represent a major possible source of income gain.

Thus one area of potential opportunity is the move from the rural to the urban sector. Risk may play a role in limiting both the ability to migrate and the size of the returns available from the migration. Migration may require an investment at the household level which involves too high a level of risk for the household to be willing to undertake. If success in the urban sector requires access to finance this too may be both hard to obtain and high cost thus increasing the risks in that sector. Lowering risk would potentially have a large payoff if returns to activities are higher in urban than in rural areas.

For purposes of understanding the implications for risk management an important distinction is between a pattern which creates wage employment opportunities and those which take the form of an extension to self-employment from rural to non-rural activities. Again, as we stressed above, the implications for risk depend on the speed with which the non-farm sector is growing. The creation of wage employment through lack of access to land is a very different pattern of wage creation than one geared to the kind of growth the TVEs in China have experienced.

Risks to wage and self-employment incomes differ but in rural areas these risks differ from those for these income sources in urban areas. This is partly due to the greater impact of seasonality on rural activity relative to urban and partly due to the lower levels of capitalisation which characterise rural enterprises in SSA and India – again the contrast with China is of importance for understanding that these are not universal characteristics of rural based activities.

### **3.2 How high is consumption in urban relative to rural areas in SSA?**

The key stylised fact for poor countries that was the focus of the last section is that incomes are higher in urban than rural areas. How much higher are those incomes and can risk management lead to those in low income sectors moving to higher income one? A recent study by the IMF (2011) addresses one dimension of that question for five SSA countries. It shows how *consumption* differs across urban and rural areas with a range of controls for household characteristics. These controls can be interpreted as the observable factors which determine differences in consumption across rural and urban areas, for example occupation and education.

With these controls the differences in consumption between rural and urban areas range from 12 per cent in Mozambique and Zambia to 21 per cent in Ghana. The data in the study suggests that the differences in household consumption per capita across rural and urban areas in SSA are relatively modest. While similar figures for incomes are not available as incomes in rural areas are very difficult to measure it seems almost certain that differences in income are substantially greater than the differences in household consumption. The very high variance in incomes within urban areas which will be discussed below suggests one explanation which is that household form to limit the risk that individuals face in their income earning opportunities.

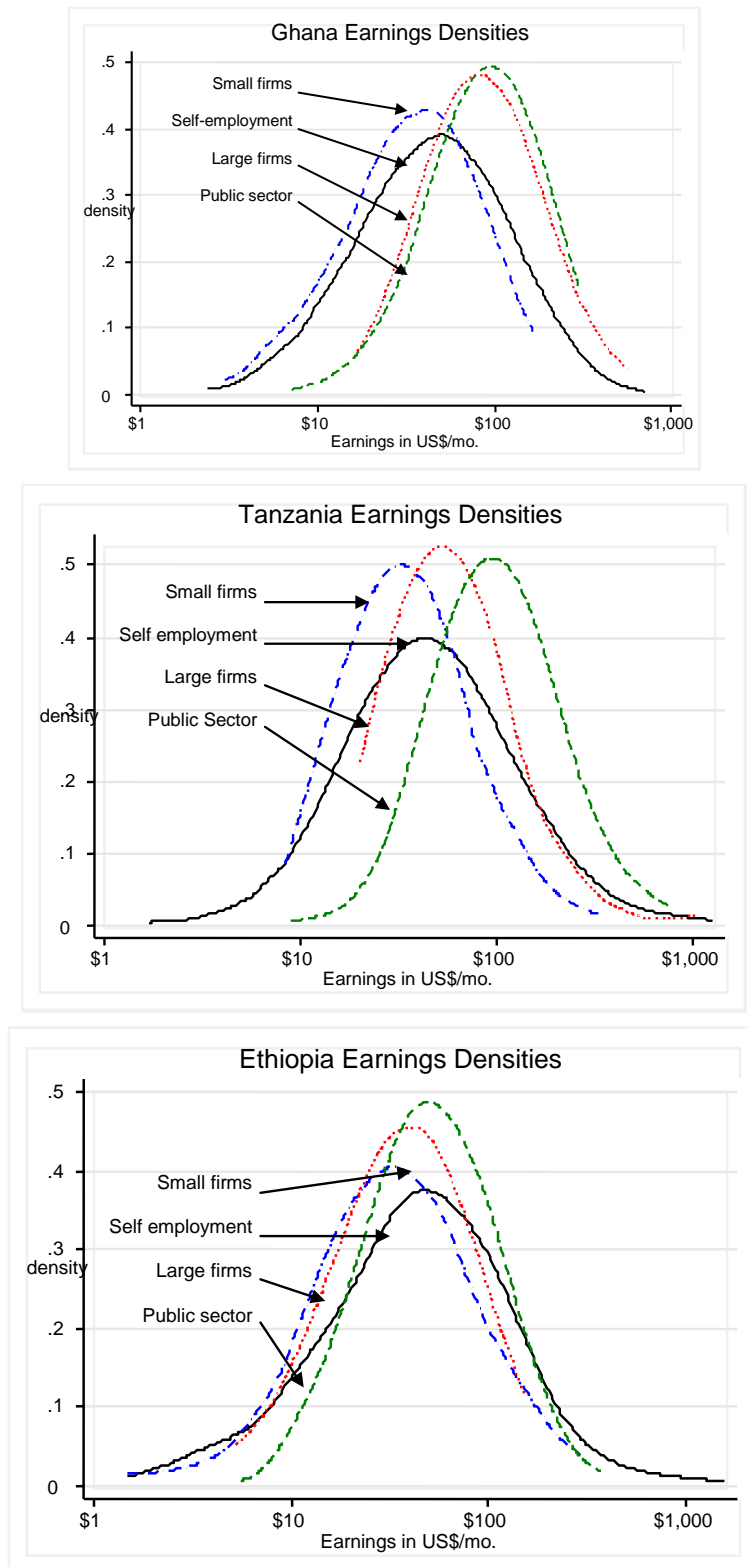
There are a range of reasons why income differences between individuals in rural and urban areas may be substantially higher than differences in household consumption. These higher incomes may result not simply from more income per hour but more hours of work available either due to a decline in its seasonality or more regular employment – a possible feature of a move from self to wage employment. Evidence for how wage and self-employment incomes compare will be considered in the next section.

### **3.3 Formality and informality within the urban sector: from low wage high risk employment to high wage low risk**

While the enterprise sector in SSA is dominated by small scale enterprises it is large scale ones which pay higher wages and, at least in SSA, such enterprises are located in urban areas. Thus in assessing how high income earning opportunities are in urban compared to rural sectors the size distribution of enterprises needs to be considered. An important feature of labour markets in SSA over the last two decades has been the expansion of employment in

urban areas concentrated in smaller scale activities whether operated as self-employed concerns or as small firms.

**Figure 2. Individual Income Distributions by Occupation Category**



A common characterisation of such labour markets is that a high wage, low risk, formal sector exists in parallel with a small scale informal sector which is one where incomes are much lower and risk much higher. As is well known there are considerable practical difficulties in measuring incomes in poor countries but recent work has shown this to be possible and has made possible a comparison of wage earners and the self-employed in urban areas.

Figure 2 above, which is taken from Sandefur, Serneels and Teal (2007), shows urban earnings for Ghana, Tanzania and Ethiopia across the range of private and public sector enterprises. The data from Ghana and Tanzania is from 2004-01, while that for Ethiopia is from urban labour force surveys for 1994 and 2000. A striking feature of the distribution of earnings for all three countries is the substantial degree of overlap between the categories of incomes that the Figure identifies. The data distinguishes large from small firms where small is less than 11 employee. It also identifies workers in the public sector. It is clear that for both Ghana and Tanzania those working in the public sector and in larger firms earn more but that there is very little difference in the average earnings of those self-employed and those working in small firms. There is an important divide based on the size of the enterprise but within the small scale there is little to distinguish self from wage employment.

In seeking to move an economy towards a more formal structure an increase in the scale of enterprise is a central feature. While not the focus of the formality/informality divide a large literature has addressed the sources of firm growth. What then do we know about the processes that enable firms to scale up their operations? As firms grow in size many of the dimensions by which they operate change. These include the complexity of their management, the skills of their workforce and the products they produce. It may be the case that firms which grow do so in part by changing the products they produce or it may be the case that they produce products of higher quality within the same product range. Navarro (2008) and Goldberg et al (2010) show for Chile and India respectively that changes in product mix are important aspects of increasing output. This process by which new and implicitly higher value products are aspects of a firm's growth process is what is referred to as movement up the value chain. Higher value-added per employee translates into higher income for the factors used in the firm's production. The labour market reflection of this firm level process is the increases in human capital that are being used in the production process.

In poor countries the most important component of value-added is unskilled labour and a move up the value chain may have two quite different aspects. It may involve the substitution within a sector of higher for lower skilled labour. Alternatively it may involve the expansion of sectors in which relatively unskilled labour is a more important component of value-added. It is the latter process which is part of a move up a value-added chain which will benefit the poor as it is the poor who are most reliant on the incomes from their labour. A shift in labour from the agricultural to the manufacturing and service sector in which labour, rather than land, is the most important source of value added ensures that structural change can lead to income gains for the poor if the returns from their labour are higher in manufacturing than in agriculture.

Such a shift has for many countries involved a change to the structure of their exports. For the supply of output to expand rapidly access to the international market is usually critical. While this is particularly obvious for small countries it has proved true too for China. Such access depends on the ability of the country to compete and that depends on both the prices of their factors – particularly that of labour – and the efficiency of the firms in the exportable sector.

Part of this process may be international with firms producing their output across international boundaries. The OECD has recently produced data showing the importance of this process by which the value of the gross output of exports may mislead as to the importance of value-added in exporting , OECD (2013). The data the OECD has produced enables the relative importance of foreign and domestic value-added in exports to be measured. The OECD (2013) data covers three countries which have seen rapid growth of incomes - Mexico, Brazil and Indonesia. The ability of a country to link into the international value chain enables it to exploit its comparative advantage at least initially in low cost labour.

The country note from the OECD (2013) for Indonesia shows that the foreign content of gross exports is relatively low in the primary sector and for food products, but Indonesia is well connected to global value chains in industries such as machinery, electronics and textiles. For machinery, 40% of the value of gross exports consist of embodied foreign value-added, indicating that Indonesia is involved in processing activities. The percentage is slightly lower for textile products and electronics, but a high percentage of imported intermediate inputs in these products are used to produce exports.

A common factor across Mexico, Brazil and Indonesia over the half century after 1950 was the increasing importance of trade in their economies. This stands in marked contrast to most economies in SSA. For the SSA economies for which the PENN World Table gives data for the period from 1950 (we exclude Mauritius which has a much higher level of income) - Uganda, the DRC, Nigeria, Kenya and Ethiopia - there was only a very modest increase in their integration into the international economy.

It is possible to look in more detail into the firm sector of one of these economies, Ethiopia Söderbom (2012). Over the period from the late 1990s until 2008 the number of manufacturing firms in Ethiopia expanded rapidly from less than 700 to more than 1600. Yet the share of manufacturing in aggregate output did not change. Söderbom (2012) shows that this rapid growth in the number of firms was associated with a decline in their average size which fell from nearly 120 to just over 60. Over the period from 2004 to 2008 there was a substantial fall too in the median size of firm which in 2008 was some 19 employees. This figure comes from data which only includes firms with more than 10 employees. As the survey which covers micro enterprises(those with less than 10 employees) shows a figure of 43,338 for the number of these firms clearly the median size of enterprise in Ethiopia is less than 10. Small size, in the context of SSA economies implies a lack of the attributes of formality.

It was noted above that evidence for Chile and India pointed to a process by which firms grow in part by changing the products they produce or by changing their quality. The data for Ethiopia enables both these aspects to be investigated. It is found that “while it thus appears true that product choice is part of the answer as to why large firms produce more value-added than small firm, this effect is not very strong. That is, even conditioning on product fixed effects, the value-added size gap remains quite large.” (page ii143)

The other reason adduced for changing productivity with size is that larger firms do produce higher quality products. Again this can be tested with the Ethiopian data which has product prices and the finding is that there is no evidence that larger firms produce goods of higher price.

Thus both the mechanisms that have been found important in other economies are absent from the Ethiopian ones. The study finds that only 29% of the value-added size gap can be attributed to differences in product selection across small and large firms and none to quality differences. The implication is that large and small firms are using very different technologies to produce rather similar goods. One possible interpretation of this finding is that large firms face lower capital costs which reflect the lower risks of lending to them. If so then policies toward risk management can be expected to play an important role in enabling firms to scale up their operations.

#### **4 Policies towards Risk Management**

The Ethiopian case study documented in the previous section points to potentially formidable barriers to formalization. It is not simply that firms are failing to become more formal it is that small scale informal firms are becoming an increasing feature of the economy. While census based firm level panel data is scarce in Africa labour market data is more readily available and at least over the 1990s Kingdon, Sandefur and Teal (2006) document a pattern, within the urban sector, of increasing informality as where job growth is occurring it is primarily in self-employment.

Thus in focusing on policies towards risk management relevant for the poor economies of SSA, and to a lesser extent South Asia, those which can reverse the present process of increasing informality are critical. It was noted in the introduction that a central theme of the WDR was how countries can combine the benefits of both flexibility and formality.

Small scale enterprises can be characterized as ones which are flexible in their labour markets but inflexible in their products markets as the firms have a narrow product range and lack the technology that enables them to produced higher quality products. Larger firms which are more formal do have greater flexibility in their product range but have failed, in the main to be sufficiently efficient to be able to enter the export market. We thus turn in the next section to one possible route to formality through trade policy.

#### **4.1 Routes to greater formality – trade policy**

The sections above have made the distinction between economies whose growth path has been associated with greater formality and those where this process appears not to have been possible. In this section we review the evidence for one of the possible paths to formality through changes in industrial structure.

The most recent and ambitious attempt to use trade policy to promote the growth of Africa was the

African Growth and Opportunity Act (AGOA) which was signed into law by the US Congress on May 18th 2000, with the broad objective of boosting exports from SSA Africa to the US by eliminating tariff barriers on a large number of their exports. AGOA was initially due to expire in 2008, however it was subsequently extended and it is now set to expire in 2011. A report reviewing the evidence of the effects of AGOA has been compiled by Condon and Stern (2010). They find that a common finding across all the studies is that exports under AGOA are highly concentrated by country and product grouping.

“AGOA exports in 2001 and 2002 were overwhelmingly dominated by previously low tariff petroleum products (which essentially switched from MFN to AGOA after 2000) – 89 percent (USD\$6.8bn) and 81 percent (USD\$6.9bn) of AGOA exports in 2001 and 2002 respectively consisted of oil exports from three countries (Nigeria, Angola and Gabon). The balance was explained principally by apparel exports, which grew rapidly after the introduction of AGOA – from USD\$337m in 2001 to USD\$800m in 2002. These early apparel exports were largely accounted for by a small group of countries - Kenya, Lesotho, Madagascar, Malawi, and Swaziland – all of whom were eligible for the special apparel rule of origin which allowed them to source fabric from anywhere in the world” (Page 22)

The study notes that it has been argued that overly restrictive rules of origin deny producers in developing countries the freedom to choose the source of their inputs and instead require a high level of in country or domestic processing. However the study also finds that Mauritius preferred to pay the tariff and not abide by the rules of origin as specified by OGOA – suggesting that the problem lies not in access to markets being restricted by tariffs but by the underlying productivity of the firms in the economy.

#### **4.2 Routes to greater formality – industrial and labour market policies**

In a recent paper Gelb, Meyer and Ramachandran (2013) consider another dimension of policy which may explain the inability of firms in Africa to become more formal. They ask: Africa may be poor, but is its industrial labour cheap?

One premise on which the policy of promoting a more formal industrial structure in Africa is based is that unskilled labour is relatively abundant in poor countries and that this provides the basis for a comparative advantage in labour intensive products. It is argued that as wages rise rapidly in China that is creating an opportunity for SSA to enter the international market

which has been dominated by China for the last decade. Gelb, Meyer and Ramachandran (2013) raise the question, which is central for this policy, namely whether the fact that SSA is undoubtedly poor translate into low cost labour in the sense that it is low cost relative to its competitors and in efficiency adjusted terms.

They show that while labour costs are lower in some Africa countries on average across the countries for which they have data costs are higher in Africa than would be predicted by their level of GDP - given a wide set of controls for the size of enterprises and their levels of human capital (Tables 4 and 5).

A remarkable aspect of their results is the strong association of labour cost with firm size which they find to be quadratic in the logarithm of firm size. As there are controls for education this suggests that the route to formality involves more than an increasingly skilled work force as measured by years of education. Why are larger firms able to increase the earnings of workers and what role might policies towards play in this process?

There are many possible reasons for the association between size and earnings but the one most closely relevant for a focus on risk, on which we have already focused, is that capital costs may differ as a function of the size of firms and that these differing capital costs may reflect the risks involved to lending to firms of differing size. If this is part of the reason for the association between size and earnings then policies that lower such cost will promote more formality and set off a virtuous circle by which lower capital cost will enable more investment to occur which will further lower costs and promote formality.



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