

Informal Sector and Small Firms: Alternative Approaches for Support and Employment Creation

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1. Introduction

Traditionally, provision of credit, technical assistance, and marketing support has formed the standard package of services to the informal sector and the small and micro enterprises (SMEs) in developing countries. The results, at best, have been mixed. Alternative approaches to supporting this sector, which can be more effective, have received considerably less attention.

SMEs have also been focused upon for their potential in creating employment, especially in developing countries. Based on the readings, I present here alternative approaches to the “informal sector problem” and also present approaches to supporting small firms, which can lead to sustained increases in employment.

2. The Informal Sector Problem: Traditional Vs. Alternative Approaches

Informal sector represents an unregulated entrepreneurial sector that behaves like small firm sectors with the self employed comprising the core (Maloney, 2003). The standard approaches mentioned earlier can be classified as supply driven approaches (SDA) (Tendler and Amorim, 1996). There are a number of reasons why I may not want to approach the “informal sector problem” with the standard approaches mentioned above. I explain some of the main reasons below.

2.1 Shortcomings of the Standard Supply Driven Approaches

Broadly, the reasons can be classified into two categories. The first deals with the nature and design of the programs themselves and the second relates to the characteristics of the firms and the sector they are designed to assist. With regard to the nature of the programs, one of the major drawbacks of SDA has been its focus on micro level conditions without regard to the

overall macroeconomic policies in the economy such as those relating to exchange and interest rates etc. which play a crucial role in the performance of this sector (Mead and Liedholm, 1998 and Levy et al, 1999). Macroeconomic policies in a country frequently shape the opportunities and threats to this sector especially in the context of increasing economic globalization (Haggblade et al, 2002). Second, in stagnant economies, these approaches, especially provision of micro-credit, may result in merely redistributing poverty as new entrants divide the existing market into smaller and smaller segments (Haggblade et al, 2002). Third, as these programs often aim at providing employment for surplus labor through credit assistance for opening of new firms, in a stagnant economy, it may lead to “low” road to competitiveness based on low wages and almost nil or very weak labor rights (Schmitz and Musyck, 1994). These programs often do not stress upon innovation and flexibility in improving the competitiveness of firms.

At the firm or sector level, the major drawback of SDA has been its tendency to focus on the weaknesses of the sector and the firms and presume that they are pathetic and hence need to be supported (Tendler and Amorim, 1996). The facts may just be the opposite. In several cases, small firms play a major role in the economy at national and even international levels. For example, in Japan and South Korea, small and medium enterprises have played a very significant role in exports (Levy et al, 1999). Even in a developing country like India, small firm clusters in Tiruppur in Tamil Nadu and Ludhiana in Punjab have been noted for their remarkable success in garment exports. Second, SDA provides no incentives to the institutions providing them to improve their performance as their aim is to just provide the standard services. This leaves the firms to find markets for their products and monitor quality on their own leading to significant transaction costs (Tendler and Amorim, 1996). Third, the standardized services are targeted at a large number of firms based on the presumption that there are problems generic to all firms. It fails to assist the firms in producing quality goods for

confirmed orders or contracts which is often one of the most serious problems faced by them (Tendler and Amorim, 1996).

2.2 Alternative Approaches

In thinking of alternative approaches to the informal sector problem, it is important to keep in mind that any attempts to eliminate it or to bring it into the 'formal' category through expansion of rules and controls can exacerbate the very conditions that give rise to it (Portes, 1995). Therefore, the approaches should be formulated keeping in view the overall objectives of the macroeconomic policy rather than just trying to introduce more controls and regulations.

Demand Driven Approaches

Demand driven approaches (DDA) to assisting the informal sector and the SMEs have several advantages over SDA in improving performance both at firm and/or sector level and at support agency level (Tendler and Amorim, 1996). DDA focuses on providing the SMEs with a market for their products, associated technical help and often finance. Procurement can be both by government agencies (Tendler and Amorim, 1996) and by large private firms in subcontracting relationships as in the case of Japan (Levy et al, 1999). It is also more effective in reducing the transaction and monitoring costs of purchasing and ensuring quality from the SMEs and may lead to lower costs and better quality. It focuses on customized assistance to firms and is also more problem and results oriented due to fear of rejection and non-renewal of contract. Due to its focus on groups of small firms, it also leads to positive externalities through sharing of orders, specialization, joint purchase of inputs, and joint solving of problems (Tendler and Amorim, 1996).

However, the suggestions with regard to DDA by Tendler and Amorim (1996) must be implemented in totality as some of them may lead to problems when implemented improperly. For example, in India, several state governments have made it mandatory for government

agencies to buy only from SMEs. In some cases, this has proved be counterproductive as the purchasing units have no incentive to reduce costs, improve quality and deliver on time. Second, it is also important that contract should be awarded to a group of firms rather than a single firm and payment should be made only upon complete delivery. They also suggest that making advance payment to these firms eliminates the problem of lack of working capital for them. However, in the absence of proper monitoring this may lead to delays and even outright non-delivery in some cases as happened in some states in India during the mid 1990s. Subsequently the practice of making advance payments was stopped. The purchasing and support agencies need to be extra careful in monitoring the firms when such advance payments are made.

Role of Supply Chains

Focusing on sub-sector specific supply chains enables designing cost-effective interventions by focusing on large numbers of similar firms facing similar opportunities or constraints (Haggblade et al, 2002). Like DDA, it also focuses on final markets but is more comprehensive as it emphasizes upon both backward and forward linkages to suppliers and markets respectively.

Institutional Approaches

Flexible institutional coalitions involving public, private agencies, and NGOs can play an important role in designing cost-effective interventions (Haggblade et al, 2002). At the institutional level, regional and local institutions and organizations may be more transparent, closer to the needs of the SMEs and more accountable than central institutions and thus may have more incentives and pressures to show better performance (Scmitz and Musyck, 1994 and Levy et al, 1999).

3. Employment Creation

Many SME support programs aim at employment creation either through starting of new firms or through expansion of existing ones (Mead and Leidholm, 1998). These programs also aim at preventing loss of employment through contraction or closure of existing firms. I outline below some of the major approaches to supporting small firms that are likely to lead to sustained increases in employment. Here again, characteristics of the programs themselves and those relating to the firm/sector play an important role.

Overall Policy Framework

As mentioned earlier, it is important to realize that overall macroeconomic environment plays an important role in the creation and expansion of SMEs. Broad based macroeconomic policy reforms aimed at creating a more dynamic economy can be very effective in creating productive employment in SMEs (Mead and Leidholm, 1998).

In many cases, government regulations favoring large firms such as in their access to inputs, imported technology and in procurement may significantly affect employment creation in SMEs. Reforming government policies in such cases can be an effective instrument.

Support Systems at Firm Level

Support systems at firm level should be designed keeping in mind the different target groups both at firm and worker levels and the overall policy objectives. For example, it is important to identify those firms which survive and grow beyond the critical first two years as support programs tend to be more effective in the later phases of growth of firms (Mead and Leidholm, 1998, and Schmitz and Musyck, 1994).

Similarly, it is important to decide whether the objective is to reduce large scale poverty or to achieve growth through improved productivity. Very small and micro firms can be an important target for support systems aiming primarily at poverty alleviation as these are mainly

survival type activities. For these firms, provision of small amounts of working capital can be very effective (Mead and Leidholm, 1998).

Support systems aiming at growing firms need to provide a much wider range of services than just working capital. The most serious problem faced by these firms is in finding market for their products and suppliers for inputs (Mead and Leidholm, 1998). To ensure cost-effectiveness, possible approaches in such cases may include focusing on specific sub-sectors such as garments, furniture etc, channeling existing assistance projects to these sectors, and encouraging market-based solutions by improving the information available to buyers and sellers (Mead and Leidholm, 1998). To ensure market for their products, government policies favoring procurement from SMEs can also be a very effective tool in creating productive employment (Tendler and Amorim, 1996).

Role of Technical Change

Support programs also need to bear in mind the distributive impacts of any new technology on employment. In this context, the conclusions of Gotsch (1972) are very relevant. In predominantly rural areas, any labor-saving technical change in agriculture would lead to increasing unemployment and consequently to more new entrants in rural non-farm enterprises. Similar impact can be expected in the case of urban SMEs where new labor-saving technology would lead to unemployment. Support programs need to focus on these unemployed workers by supporting them to either find new employment in existing expanding firms or in starting their own firms through appropriate skill-enhancing training programs, provision of working capital, and through providing a market for their products through demand driven approaches.