RESEARCH BRIEF

Job creation and small and medium size enterprises

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KEY FINDINGS

- **Small and medium size enterprises account for around 50 per cent of employment in Africa.**
- **SMEs grow fast, but this is balanced out by a high failure rate.**
- **Larger firms provide better wages and better job security.**

Aid providers seeking to promote employment often target their aid towards small and medium-sized businesses. This is because, globally speaking, these firms are responsible for a large part of employment in the formal sector, in low-income countries their share of employment is nearly 80 per cent. Due to the high failure rates and low wages of small and medium size enterprises (SMEs) focusing on them may not be the most productive use of aid and argue that firm size alone is too crude a measure to be of much use to policy makers. A better alternative would be to use aid to promote the growth of firms of all sizes.

Aid and small and medium-sized enterprises

At the end of 2010 the total commitments of multilateral development banks, bilateral donor agencies, and development finance institutions to support SMEs totalled around US$ 24.5 billion. This attention is seen as warranted both because SMEs are responsible for a high percentage of jobs in low-income countries, and because they generate a large number of new jobs. When SMEs are defined as firms with less than 100 employees, then they account for around 50 per cent of employment and firms with 5-19 employees generate a disproportionate 47 per cent of new jobs in the region.

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The belief in the importance of SMEs then, is not completely unwarranted. However there are two potential problems that much of the existing literature on jobs and job creation does not address; firm survival, and the quality of jobs. Evidence from enterprise surveys of nine African countries, as well as panel data of Ethiopia shows us three key things about the role SMEs play in creating new jobs and providing quality jobs.

1. The positive and negative sides of SME job creation balance each other out

If SMEs survive, they tend to grow faster than larger firms and therefore create more jobs. However SMEs have a higher failure rate than larger firms. These two effects roughly balance each other out; consequently the expected rate of growth is similar between SMEs and larger firms.

2. Larger firms provide better job security

Larger firms are more stable and less likely to fail. Due to this higher survival rate larger firms offer much more job security than SMEs.

3. Larger firms provide better wages

In fact larger firms provide significantly higher wages. A firm 10 per cent larger than another will typically provide wages that are 2.9 per cent higher.

Part of this discrepancy is due to higher worker skill in larger firms, but it is also due to the higher profitability and productivity of larger firms. Having established that targeting aid at SMEs will not necessarily generate more jobs, and that any jobs it does generate will be less secure and worse paid than those generated by large firms, it is important to look at alternative ways aid could be used to encourage job creation.

Promoting growth in all businesses

There are four key ways in which aid could better support the creation of quality jobs:

1. Focussing on the right target

This suggestion flows naturally from the discussion above. If SMEs do not generate more job growth, and provide lower quality jobs, then they should not be the target of aid aimed at job creation. The question then becomes, what is the right target? As both SMEs and larger firms will create jobs if they are growing, then the right approach is to use aid to reduce the constraints on the growth of firms, regardless of size.

2. Strengthening the investment climate

One key way to reduce the constraints on the growth of businesses is to direct aid at improving the investment climate. Both institutional and regulatory reform and the closing of the infrastructure gap are crucial to improving the investment climate.


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The typical approach of using the World Bank's Doing Business ranking system to identify the regulatory constraints to growth that aid should target is misguided, as Doing Business is designed to be a cross-country benchmarking tool rather than a country-level diagnostic tool. Instead aid should be used to help manage a close relationship between the public and private sector which should enable the identification of reform which actually helps firms to grow.

Turning to the infrastructure gap, donor assistance is likely not to be able to provide the estimate US$ 93 billion a year needed to close the gap without causing some highly negative side-effects when aid is pulled from life supporting projects and programmes, or an across the board doubling foreign assistance. Consequently donor money may be better used in creating instruments, such as investment guarantees, which encourage greater private investment in infrastructure.

3. Building firm capabilities

A large determinant of a firm's productivity is its stock of accumulated knowledge, or its collective capabilities. Aid could be used to attract foreign direct investment into low-income countries, as this brings in high capability firms which other firms can learn from. Aid could also be used to invest in management and technical training, which often have a large payoff in terms of increasing a firm's productivity, and thus tend to increase employment.

4. Targeting programmes at firms of all sizes

While the constraints faced by SMEs and larger firms do differ, they do not differ as much as one might expect. For both, unreliable access to electric power is the most pressing constraint. For SMEs access to finance and land are key constraints, whereas larger firms see corruption and crime as a major problem. The large variety of different constraints identified by firms suggests that donors should work with firms to provide them support tailored to their needs.

Sometimes finance may be the bottleneck, sometimes access to land, and sometimes lack of managerial capacity. If these bottlenecks can be identified then aid can be used to overcome them, and to therefore promote job creation.

The main insight of this analysis is that firm size alone is too crude a measure of employment potential to be of much use to policy makers. Instead policy makers need to focus on all firms, helping small firms to survive and grow, and supporting larger firms seeking to increase their size.

IMPLICATIONS

- **Policy makers need to focus on all firms, helping small firms to survive and grow, and supporting larger firms seeking to increase their size.**
- **Using aid to strengthen the investment climate and build firm capabilities would be beneficial for firms of all sizes.**

This Research Brief is based on WIDER Working Paper 2012/94 'Is Small Beautiful? Small Enterprise, Aid and Employment in Africa' by John Page and Måns Söderbom.