

5. Small-scale activities and the productivity divide¹

It is widely recognized that small firms greatly predominate over large firms around the world, both in number and the share of the labour force they employ. This is particularly true for developing regions, where besides the share of small firms in the formal economy, the industrial structure is characterized by the high share of self-employed, and of micro- and small firms in the informal economy.

In this context, it is worth remembering that small and medium enterprises (SMEs)² have special advantages that give rise to at least four important – if not unique – contributions to economic development. The first and foremost characteristic is that SMEs are said to be creators of *employment opportunities* and therefore hold an important key to employment and poverty reduction. SMEs use relatively less capital to create these jobs compared with those created by larger enterprises. This is a salient feature, especially for developing economies with an abundance of labour and a shortage of capital. Second, SMEs are claimed to be the main *source of economic growth and innovation*. By virtue of their being the source of considerable innovative activity, they are responsible for the development of entrepreneurial talent and export competitiveness. Third, the presence of SMEs in the economy tends to increase competition, which promotes greater economic dynamism. Fourth, SMEs contribute to a *more equitable distribution* of income, not only by providing employment opportunities – especially for poorer people – but also because SMEs tend to be more widely dispersed geographically than larger enterprises, supporting the development and diffusion of entrepreneurial spirit and skills, and thereby helping to reduce economic disparities between urban and rural areas.

Given these considerations, together with the widespread empirical evidence that small-scale economic activities are less productive (especially in the informal economy), the potential and also the limits of small-scale economic activities for raising living standards become clear. The implication here is a potential “productivity” divide between developed and developing countries that is arguably structural in nature. The existence of such a divide is all the more worrying when it is recalled that macroeconomic volatility is greater in developing than in developed countries – and is especially onerous for small firms.

Will competitive markets not automatically ensure that less productive firms are forced out, leaving room for bigger firms with higher productivity but less potential to create employment? Why is it that small firms still dominate the economic structure even in more developed economies? What is their competitive

¹ This chapter is based on the work of Vandenberg (2004) and Mazumdar (2004).

² SMEs in this chapter will generally regroup micro-firms, small firms, medium firms and those who are self-employed. When necessary, specific distinction will be made.

advantage? Should development strategies ignore small-scale activities in order to raise overall productivity of economies? Does the dominance of small firms hinder or harm poverty reduction? Or is there a way to enhance productivity growth in small firms?

This chapter attempts to answer these questions, first by defining what small-scale enterprises are and describing what their contribution to economic development and employment creation is (section 1). Section 2 presents evidence on the productivity differences between small and large firms. Section 3 explores why small firms, disadvantaged relative to large firms, are not driven from the market. As small firms often provide lower incomes for their employees, section 4 addresses the wage gap and the broader social dimensions of the productivity divide. Section 5 reviews some of the organizational models through which the small-firm productivity disadvantage can be addressed. Section 6 concludes this chapter with a summary of the political implications for development strategies drawn from the present research.

5.1. A definitional and empirical overview

What are small and medium enterprises?

Small and medium enterprises are a very diverse group, covering a wide range of business activities that include agricultural products for the village, the corner store and shops selling food and drinks, as well as much more sophisticated enterprises selling engineering and computer products for domestic and/or overseas markets. Given this wide range of activities, some SMEs might not be able to provide sufficient income for their owners and employees to overcome poverty. Others may be thriving and providing a decent living standard to their workers and owners. SMEs also function in very diverse markets at all levels – urban, rural, local, national, regional and even international. Because of their diversity, they possess different levels of skills, capital, sophistication and growth orientation.³

There is no single definition of an SME. Different indicators are used to define them, such as employee numbers or financial criteria. However, SMEs are generally considered to be private independent firms which employ fewer than a given number of employees. This number varies across countries. The most frequent upper limit designating an SME is 250 employees, as in the European Union. The United States includes firms with fewer than 500 employees. In developing countries, the cut-off point is between 100 and 250 workers. Small enterprises are usually considered to have fewer than 50 employees while micro-enterprises have at most ten or, in some cases, five employees. As will be seen, the definitional variability in employment thresholds is a source of bias when it comes to evaluating the level of productivity.

³ The data presented in this section on SMEs do not usually include the informal economy (see section on the informal economy and small-scale activity).

For example, in terms of financial assets, SMEs in the European Union must have an annual turnover not exceeding €40 million and/or a balance sheet-valuation not exceeding €27 million.⁴ Table 5.1 illustrates the variety of definitions that currently exists in selected developing and developed economies.

The empirical evidence on SMEs

In most developing and developed countries, SMEs comprise 90 per cent of all enterprises. For example, according to OECD (2002), SMEs represent between 96 and 99 per cent of the total number of enterprises in most OECD countries. Table 5.2 shows that micro-enterprises (0 to 9 employees) account for 78 per cent of all firms on average, while firms with 0 to 49 employees account for at least 95 per cent of all firms. Only 0.5 per cent of enterprises employ more than 500 workers in the OECD countries.

Why are SMEs important? Their contribution to employment and growth

Microeconomic evidence from individual countries supports the claims that SMEs contribute to socio-economic development through different channels.⁵ However, only a few cross-country studies are available on the SME contribution to the economy, because of the absence of comparable international data on SMEs. Here, using data gathered by Ayyagari et al. (2003), an attempt is made to

Table 5.1. Current definitions of manufacturing SMEs in selected economies

Economy	Definition of manufacturing SMEs	
	Criterion	Size
Indonesia	Employment	<100
	Assets	<Rp 10 billion (US\$1.4 million)
	Sales	<Rp 50 billion (US\$7 billion)
Japan	Employment	<300
	Invested capital	<Y 300 million (US\$3 million)
Korea, Republic of	Employment	<300
Malaysia	Invested capital	<MR 2.5 million (US\$0.7 million)
Philippines	Employment	< 200
	Assets	<P 60 million (US\$1.5 million)
Singapore	Assets	<S\$15 million (US\$9 million)
Taiwan, China	Employment	<200
	Invested capital	<NT\$60 million (US\$2 million)
Thailand	Employment	<300
	Assets	<100 million baht (US\$2.7 million)
Canada	Employment	<500
	Sales	<C\$20 million (US\$14 million)
United States	Employment	<500

Source: Hayashi, 2003.

⁴ OECD, 2002.

⁵ See Biggs (2002) for a review of literature on SMEs and their contribution to economic development. See also UNIDO (2001).

Table 5.2. Distribution of enterprises in selected economies (%) according to size-class, 1999 (or nearest available year)

Economy	0-9	10-49	50-99	100-499	500+
United States	56.8	15.8	20.7	5.2	1.5
Norway	63.0	27.6	4.6	3.9	0.8
Germany	67.5	23.7	4.0	4.0	0.8
Spain	68.7	27.1	2.4	1.5	0.2
Austria	69.8	22.4	3.3	3.9	0.6
Denmark	71.4	21.3	3.4	3.3	0.6
United Kingdom	72.0	20.5	3.3	3.5	0.7
Australia	72.6	21.8	2.8	2.2	0.6
Switzerland	79.1	15.5	2.6	2.4	0.3
Portugal	80.6	16.3	2.0	1.1	0.1
New Zealand	81.7	15.0	1.6	1.4	0.3
France	82.4	13.5	2.0	1.8	0.4
Italy	83.7	14.3	1.1	0.8	0.1
Belgium	84.1	12.0	1.9	1.6	0.4
Sweden	84.7	11.4	1.8	1.6	0.4
Finland	85.3	10.7	1.8	1.8	0.4
Czech Republic	88.8	8.1	1.5	1.4	0.3
Mexico	90.3	6.5	1.3	1.5	0.4
Poland	90.3	7.3	1.0	1.2	0.3
Turkey	95.0	3.2	0.8	0.9	0.2
Average	78.4	15.7	3.2	2.3	0.5

Note: Countries are ranked from lowest to highest in terms of distribution enterprise size.

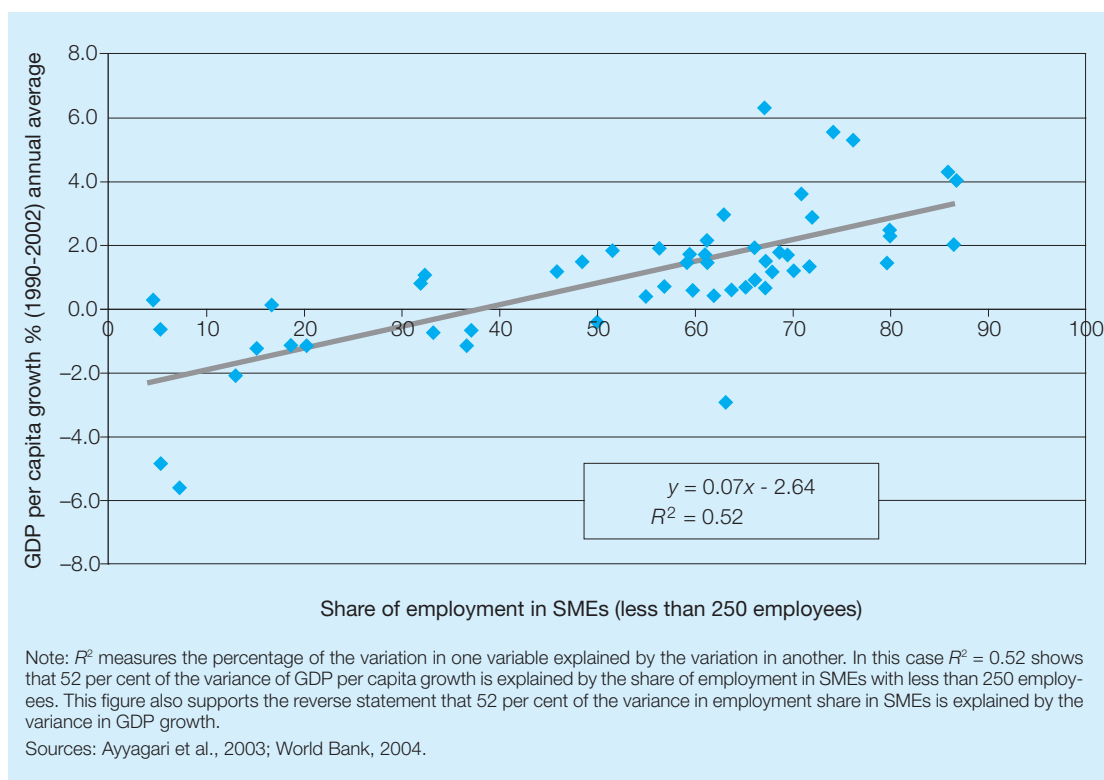
Source: OECD, 2002.

investigate if SMEs are associated with higher economic growth rates on a cross-country level.⁶

A simple correlation (figure 5.1) shows that the share of employment in SMEs (a cut-off point of less than 250 employees) in total employment is positively associated with higher rates of GDP per capita growth. In other words, countries with a high share of employment in SMEs tend to have higher growth in GDP per capita. For example, a 1 percentage point increase in the share of employment in SMEs in total employment is associated with an increase of .07 percentage points of growth in GDP per capita.⁷ However, this analysis using cross-country data is unable to conclude that SMEs exert a causal relationship on economic growth (owing to the many other determinants of economic growth). A note of caution applies here; this relationship may go both ways, because it is affirmed that fast-growing economies also tend to have a vibrant

⁶ Data for economic growth (GDP per capita) from World Bank (2004).

⁷ The results are similar, even using the official definition of SMEs (SMEOFF) which varies from country to country.

Figure 5.1. Correlation between share of employment in SMEs and GDP growth

SME sector. Similar results are also achieved by Beck et al. (2003). However, they were not able to show, at least at the cross-country level, that SMEs reduce poverty. This relationship is one – but not the only – reason why political interest in SMEs has a long tradition (box 5.1).

Employment is widely regarded as one of the most effective ways of overcoming poverty. Therefore, assisting in designing and implementing strategies that promote employment creation can contribute to the objective of poverty alleviation. And the SME contribution to employment creation is considerable. An OECD study⁸ affirms that SMEs account for 50 to 60 per cent of total employment in most developing and developed economies – indicating that they are responsible for more employment than the large firms or employment in the public sector and state-owned enterprises. SMEs engaged in manufacturing often account for an even larger share of manufacturing employment, which may rise to as high as 80 per cent, as table 5.3 shows. In developing countries, the role of manufacturing SMEs is even more important, as they are the major sources of employment growth and value added. This applies equally to the transition countries, where large, inefficient state-owned enterprises are giving way to much smaller and more efficient private entities.

⁸ OECD, 2002.

Box 5.1. Origins of policy interest in SMEs

The notion of SME and entrepreneurship development appeared on the growth and development landscape as early as the late 1940s, with the introduction of targeted policies (grants, subsidized credits, special tax treatment, etc.) and the establishment of small business or SME support agencies by governments. For example, publicly funded SME agencies were set up in 1948 in Japan, 1953 in the United States, 1954 in India, 1966 in Tanzania, and in 1976 in Turkey.

Despite a long history of development efforts, SMEs (including those in the informal economy) were perceived as a synthetic construction mainly of “social and political” importance throughout the 1980s and well into the late 1990s. Although domestic SMEs and the informal economy constituted most of what could be (and still are) deemed as “the” private business activity in most developing countries, private sector development strategies advocated for and implemented in these countries were skewed towards the needs of large-scale business, including foreign-invested ones. This type of policy advice was partly motivated by the rather disappointing results achieved through extensive SME support systems operated in developed countries since the 1970s.

Source: OECD, 2004.

The importance of the SME sector in terms of employment varies greatly across countries and also within income groups. For example, in the low-income group in Azerbaijan, Belarus and Ukraine around 5 per cent of the formal workforce is employed in SMEs; this share is more than 70 per cent in Indonesia and Viet Nam. The range is between 4.5 per cent (Belarus) and 86 per cent (Thailand) in the middle-income group and between 20 per cent (Slovenia) and 82 per cent (Portugal) in the high-income group of economies in the world (Ayyagari et al., 2003).

Figure 5.2 shows the SME contribution to total employment and GDP across different income groups. A marked increase is observed in the SME sector’s contribution to total employment from the low- to the high-income countries (over 60 per cent). The SME share of GDP follows a similar trend, almost doubling from around 20 per cent of GDP in the low-income countries to over 40 per cent in high-income countries.

These data are somewhat misleading, however, as they exclude the informal agriculture sector and own-account workers in the informal economy – both are substantial in developing countries. When agricultural and own-account workers are included, the overall share of small-scale activity of all types in the economy is greater in developing than in developed countries. The overall share of small-scale activity must therefore integrate the informal economy, as many SMEs in developing countries are operating in the informal economy.

The informal economy and small-scale activity

As stated above, a significant portion of the labour force in low-income countries works for, or owns and manages, micro-enterprises in the informal economy. The

Table 5.3. Distribution of employment in manufacturing (%), according to size-class, selected economies, 1999 (or nearest available year)

Economy	0-9	10-49	50-249	250+
Czech Republic	5.3	16.1	26.8	51.8
Germany	7.4	15.1	23.2	54.5
Denmark	7.8	19.2	26.3	46.6
Sweden	7.9	15.5	21.2	55.5
Belgium	8.1	19.7	20.4	51.7
Norway	9.1	21.1	28.3	41.6
United Kingdom	9.4	17.9	25.7	47.0
Finland	10.3	14.1	20.2	55.4
France	10.3	20.1	22.3	47.3
Korea, Republic of	10.5	29.9	26.4	33.3
Austria	11.0	18.7	27.0	43.3
Japan	11.1	28.3	29.8	30.7
Netherlands	11.7	27.1	28.1	33.1
Italy	12.8	36.3	23.2	27.7
Australia	14.1	20.5	17.8	47.7
Switzerland	15.4	21.3	29.2	34.1
New Zealand	18.3	24.2	22.9	34.7
Spain	18.5	33.5	21.4	26.6
Mexico	18.9	12.0	21.5	47.6
Iceland	20.3	33.5	46.2	10.0
Portugal	27.5	32.4	24.1	16.1
Turkey	34.0	10.5	19.8	35.8

Note: Countries ranked from lowest to highest according to distribution of employment and enterprise size.

Source: OECD, 2002.

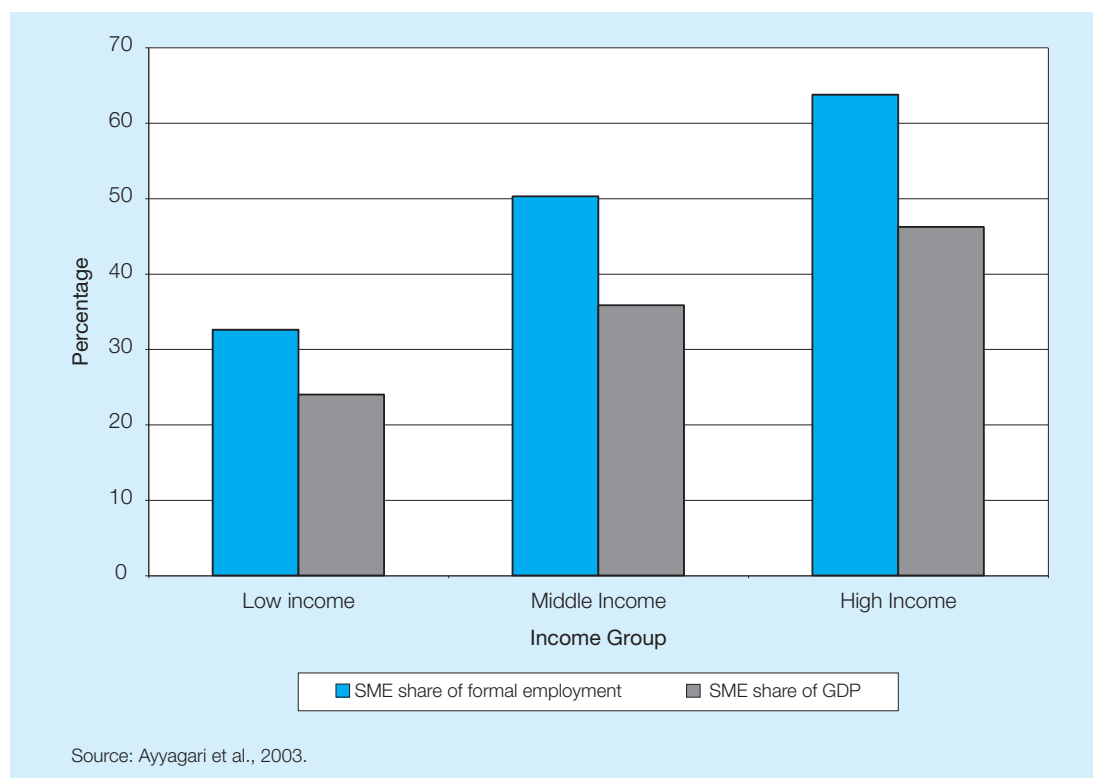
informal economy may be defined as all unreported income from the production of goods and services that would generally be taxable if reported to the state authorities.⁹ A similar but much broader definition is adopted by the ILO, which refers “to all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements ... or are operating outside the formal reach of the law”.¹⁰ Most SMEs (mainly micro-firms) in developing countries are operating in the informal economy and thus are not recorded in official data. Larger firms find it impossible to operate in the informal economy because of their visibility and size. The SME sector and the informal economy are thus closely linked.

In Africa, for example, the size of the informal economy as a share of GNP is considerable, at around 41 per cent.¹¹ For Asia, the average size of the informal

⁹ Schneider, 2002.

¹⁰ Resolution adopted by the International Labour Conference at its 90th Session, 2002: GB.285/7/2, Resolution concerning decent work and the informal economy, Nov., p. 5. For more details see ILO’s website on the informal economy at www.ilo.org/infeco

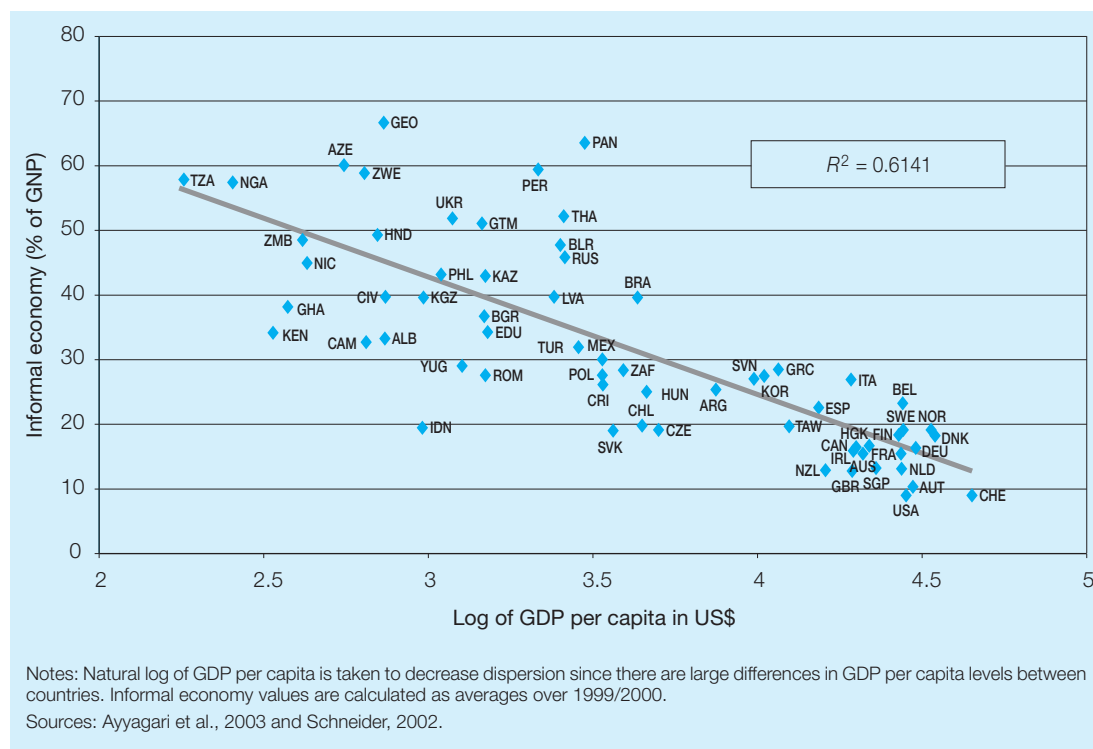
¹¹ Schneider, 2002.

Figure 5.2. Contribution of SMEs to employment and GDP, 1990-1999 (average values)

economy share is 26 per cent of GNP. However, this figure needs to be seen in perspective since Asia is home to developed economies such as Japan, Singapore, and Taiwan, China. Thailand has the largest informal economy share, at around 53 per cent of GNP, followed by Sri Lanka at 45 per cent and the Philippines at 44 per cent. India has 23 per cent,¹² while China has 20 per cent. At the lower end are Singapore and Japan with shares of 13 and 11 per cent, respectively. In Latin America and the Caribbean, the average size of the informal economy share is 41 per cent of GNP, similar to the figure for Africa. The transition economies have on average a 38 per cent share of GNP, with the highest percentage in Georgia, at around 67 per cent, and the lowest in the Slovak Republic at 19 per cent.

The developed economies of Western Europe have an informal economy ranging from 29 per cent for Greece to 9 per cent for Switzerland. The average size of the informal economy is 18 per cent in these economies. Outside Europe, Canada has an informal economy representing around 16 per cent, followed by Australia with 15 per cent, New Zealand with 13 per cent and the United States

¹² These data, however, exclude the agriculture sector, which is largely informal and often at subsistence level in developing countries. To take one example, India's informal economy would employ over 90 per cent of the labour force – if these data were included.

Figure 5.3. Informal economy and levels of development (measured as GDP per capita)

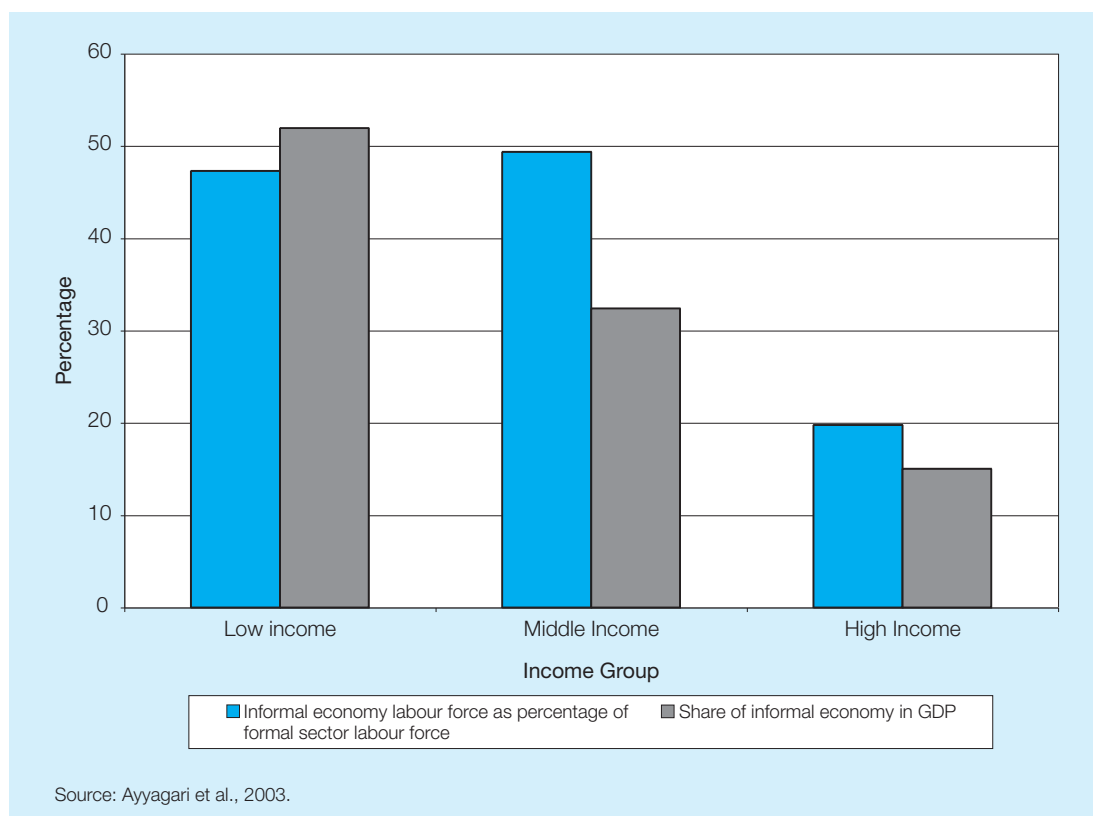
at 9 per cent. Figure 5.3 demonstrates that as countries develop (measured by GDP per capita), the size of the informal economy decreases.

Figure 5.4 shows a steady decline in the contribution of the informal economy to GDP, from low- to high-income countries. The informal economy's contribution to *total* employment also shows a general decline from the low- to the high-income group, although it increases slightly in the middle-income group.

Exports by SMEs

SMEs are also an important source of export revenues in some developing countries. Information on the SME shares of manufactured exports in selected East Asian and African developing economies and OECD countries¹³ is provided in table 5.4, which clearly demonstrates the export potential of small firms, although it implies that size thresholds may have a role to play in that potential. It should be noted that African countries which define size thresholds at fewer than 50 employees do not compare favourably with those countries whose definitions are based on a higher employment threshold.

¹³ OECD, 2004.

Figure 5.4. Informal sector contribution to employment and GDP, 1990-1999 (average values)

5.2. The productivity divide

A review of the research on small enterprises regarding productivity and employment reveals that productivity tends to rise with enterprise size: small enterprises are typically less productive than large ones. A second characteristic is that wages in small enterprises¹⁴ tend to be lower and workers' rights and conditions tend to be less adequate (i.e. job quality is lower) in such enterprises. Taken together, these characteristics indicate that a significant proportion of the workforce in many economies earn lower wages, with fewer rights, in small, low-productivity establishments.

The bias of "labour productivity" in comparing small and large enterprises

Productivity is a relationship between output and inputs. It rises when an increase in output occurs with a less than proportionate increase in inputs, or when the same output is produced with fewer inputs.

As has been discussed in other chapters of this Report, much of the research on productivity is based on the indicator of labour productivity. This measure is

¹⁴ Unless indicated otherwise, the term "small" here groups enterprises normally classified as micro-, small and medium. The actual size of such enterprises varies according to country-specific definitions.

Table 5.4. SME shares of manufactured exports, selected years and economies

Economy	Year	Definition of the SME*	Share of SME manufacturing exports in total manufacturing export (%)
Developing economies			
China	Early 1990s	< 100 employees	40-60
Korea, Republic of	1995	< 300 employees	42.4
Viet Nam	Early 1990s	< 200 employees	20
India	1991/1992	< Rs 30 m investment in plant and machinery	31.5
Singapore	Early 1990s	< 100 employees	16
Malaysia	Early 1990s	< 75 employees	15
Indonesia	Early 1990s	< 100 employees	11
Thailand	Early 1990s	< 100 employees	10
Mauritius	1997	< 50 employees	2.2
Tanzania	2002	< 50 employees	<1.0
Malawi	2003	< 50 employees	<1.0
OECD economies			
Denmark	Early 1990s	< 500 employees	46
France	1994	< 500 employees	28.6
Sweden	Early 1990s	< 200 employees	24.1
Finland	1991	< 500 employees	23.3
Japan	1991	< 300 employees	13.3
United States	1994	< 500 employees	11
Average for 6 OECD economies			24.4

*Definition varies according to the official national definition of an SME.

Source: OECD, 2004.

relatively easy to calculate and is practical in the sense that it allows for comparison of trends between countries. It is not always the best measure, however, and while its deficiencies may not pose grave concerns in general cross-country comparisons, they elicit a particular problem in comparing large and small enterprises, as explained below.

Labour productivity is a single-factor measure. It results from a calculation of value added, which is then divided by the amount of labour used.¹⁵ When the number of people employed is taken as denominator, it is called “value added per worker”. Despite its name, labour productivity is increased when value added rises through the better utilization and coordination of *all* factors of production. Value added may increase when labour is working smarter, harder, faster or with better skills, but it also increases with the use of more or better machinery, a reduction in the waste of input materials or the introduction of technical innovations. Indeed, any non-labour factor that raises value added will

¹⁵ This comprises either the number of people employed or the number of hours worked. The latter would be a more precise measure but again, because of data restrictions, the number of employees is more often used.

raise labour productivity. The term “labour productivity” is therefore correct in that any non-labour change which increases value added makes workers more productive, but is slightly misleading in that it denotes productivity in general and not that which specifically involves workers.

A productivity increase can allow for greater returns to the factors of production. If the increase in labour productivity arises from better trained, better treated or more efficient workers, it can support higher wages. If the increase in labour productivity arises from the use of additional or more productive machinery, however, it will also be reflected as an increase in labour productivity. This implies that enterprises with high capital investment should always have higher labour productivity. Statistics comparing the labour productivity of large firms with that of small firms (which normally exhibit lower capital investment) thus contain a systematic bias.

A second bias exists in the empirical research. Much of the work focuses on data gathered from industrial censuses or surveys of manufacturing firms. Manufacturing – the making of products – is much more affected by economies of scale (the more that is produced, the cheaper it gets) – than service activities. A large proportion of small-enterprise activity takes place in services, notably trading but also food service, repair work and personal services.

And there is a third bias – one that is purely definitional. While the relationship is perhaps not a linear one, productivity levels do seem to correlate with firm size, with employment quantity being the most common measure. If, by definition, a “small” firm is defined as having fewer than 500 employees in one country (United States), and only 50 in another (United Republic of Tanzania), then the productivity gap between large and small firms is likely to be understated in the former and overstated in the latter.

The extent to which these biases affect the data is not known and requires further research. Despite the limitation of “labour productivity” as a measure, much of the available evidence is based on it.

Cross-regional evidence of a size–productivity gap

A positive correlation between enterprise size and labour productivity is evident across the main regions of the developing world – that is, large firms are more productive. Table 5.5 indicates that the productivity of SMEs in the formal economy¹⁶ in ten Latin American economies ranges from one-quarter to three-quarters of that of large enterprises. Over time, the gap has decreased in half the countries surveyed but increased in the other half, suggesting no long-term regional trend.

Data for seven sub-Saharan African countries show similar results in table 5.6, with productivity rising through the five firm-size categories. There are anomalies, though, in Kenya, Côte d’Ivoire and Cameroon, which exhibit lower productivity in the largest size category relative to the second largest size cate-

¹⁶ Not including micro-enterprises.

Table 5.5. Relative productivity: SMEs and large enterprises in Latin American economies, selected years

Economy	Base year	Final year	SME productivity as a percentage of large enterprises	
			Base year	Final year
Argentina	1984	1993	44	57
Brazil	1985	1997	61	77
Chile	1990	1996	41	38
Colombia	1991	1996	48	45
Costa Rica	1990	1996	63	73
Ecuador	1991	1996	44	40
Mexico	1988	1993	48	56
Peru	1992	1994	33	25
Uruguay	1988	1995	53	48
Venezuela	1990	1995	22	25

Note: SMEs are defined according to official national definitions.

Source: Peres and Stumpo, 2000, table 9.

Table 5.6. Value added per worker index, according to enterprise size, selected African economies, 1990s (250+ worker category=100)

Enterprise size (no. of workers)	Cameroon	Côte d'Ivoire	Ghana	Kenya	Tanzania, United Republic of	Zambia	Zimbabwe
0-9	28	13	22	56	39	38	44
10-49	41	53	35	118	38	67	63
50-99	111	69	33	119	61	65	79
100-249	113	103	72	165	55	71	81
250+	100	100	100	100	100	100	100

Note: Enterprise size based on number of workers.

Source: Mazumdar and Mazaheri, 2001, p. 37.

gory. This is probably due to a large number of relatively unproductive, state-owned firms in this category. Figures for four East Asian countries, including Japan, again show a very consistent pattern of labour productivity rising through ever-larger size categories, as table 5.7 shows.

The data presented above reveal that SMEs are indeed less productive compared to larger firms in most countries of the world. How then do SMEs compete with larger firms and still manage to survive? The following section explores this question.

5.3. How do small enterprises survive?

Combining the productivity and employment figures, it appears that many workers in the developing (and developed) world are employed by enterprises with relatively lower labour productivity and consequently low incomes. In view of

Table 5.7. Value added per worker index, according to enterprise size, East Asia, selected years (500+ worker category=100)

Enterprise size (no. of workers)	Rep. of Korea	Japan	Hong Kong, China*	Taiwan, China
5-9	31	32	54*	34
10-49	42	39	61	35
50-99	59	50	66	38
100-199	56	59	71	49
200-499	81	76	82	—
500+	100	100	100	100

Note: Figures are based on an index relative to the labour productivity of the 500+ category. * = 1-9 workers. Data years as follows: Rep. of Korea (1986), Japan (1987), Hong Kong, China (1982), Taiwan, China (1986).

Source: Mazumdar and Mazaheri, 2001, p. 37.

the productivity gap, the burning question is: How do small firms survive? It is possible that the small enterprises may represent a temporary phenomenon.

Are small firms a transitional phenomenon?

Over time and as countries develop, small firms may be forced from the market by larger firms. For example, Anderson (1982) demonstrated the evolutionary phases of firms: beginning with household and artisan-level firms being replaced by small firms with wage labour, then medium-sized firms taking over and, at a later development stage, large firms becoming dominant. This line of argument was later studied by Little et al. (1987) who confirm the idea of phases of development and the eventual decline of small firms.

This argument is based on two hypotheses known as the “output composition effect” and the “social relations–economies of scale effect”.¹⁷ The theory of the output composition effect argues that as income rises, the share of manufacturing output of consumer products (produced by small firms) declines, resulting in the decreasing importance of small firms in terms of employment and output. The second line of argument deals with the notion that as countries develop and their business and financial environment becomes more sophisticated, small-scale family-based firms are gradually squeezed out of the process, since they do not possess the competitive advantage and economies of scale required to survive.

One study shows that as income increases, the share of employment in the SME manufacturing sector increases. This is partly explained by the fact that as countries develop, their capital markets strengthen, which leads to firms being operated more professionally along business lines. In addition, education also plays some role in the supply of skilled labour. In the initial stages of development, foreign investment is more crucial in the manufacturing sector than at later stages.

¹⁷ According to Weeks, 2003, p. 340.

Regarding the formal economy, a study of the manufacturing sector in nine developed and developing countries shows a diversity of SME experiences over time.¹⁸ Over periods ranging from 20 to 45 years, small enterprises in five countries captured a greater share of total formal manufacturing employment, as table 5.8 shows. In the four other countries, however, the small-enterprise share declined. The increase of employment in manufacturing was more rapid in the medium-sized firms.

Another study demonstrates that the share of manufacturing employment in SMEs has dropped only marginally in Japan during the long period of post-war industrialization. Between 1955 and 1994, this share declined only 2.5 percentage points to 53.2 per cent.¹⁹

Similar results are evident for ten Latin American countries in the 1980s and 1990s as table 5.9 shows. With periods ranging from two to 15 years, total employment in the formal SME sector grew in Chile, Columbia, Mexico and Peru, fell in Argentina, Brazil, Costa Rica, Ecuador and Uruguay and was relatively stable in Venezuela (Peres and Stumpo (2000), table 9).

A long-running debate continues in the United States on the employment contribution of small firms. The question is not whether employment in SMEs is declining but whether these firms create more net jobs than large firms. Early studies showed that small firms indeed created more jobs than large firms, thus suggesting that small firms were not being squeezed from the market due to

Table 5.8. Change in SME share of total manufacturing employment, selected countries, selected periods, 1950s–1990s

	Period		Small (10-49) ^a		Medium (50-499) ^a	
	Base year	Final year	% in final year ^b	Change from base year (%)	% in final year	Change from base year (%)
Economies with increase in small enterprise share of total employment						
Brazil	1960	1980	24	3.5	55	7.2
France	1962	1990	19	4.3	36	2.8
Hong Kong, China	1951	1996	34	11.5	47	-2
Japan	1967	1990	33	2.4	43	3
United States	1967	1987	15	3.6	47	5.9
Economies with decrease in small enterprise share of total employment						
Colombia	1956	1990	21	-10.5	n/a	n/a
Korea, Republic of	1958	1990	22	-21.5	39	n/a
Pakistan	1954	1988	11	-7.8	33	12.1
South Africa	1950	1988	12	-6.1	48	-4.2

Notes: ^a Number of employees per enterprise; ^b share of total manufacturing employment accounted for by small enterprises in final year.

Source: Weeks, 2002, pp. 13-14.

¹⁸ Weeks, 2002.

¹⁹ Mazumdar, 1998, p. 47.

Table 5.9. Production, employment and productivity in SMEs in the formal economy manufacturing sector, Latin America, 1980s-1990s

Economy	Base year = 100	Comparison year	Change in index value relative to base year		
			Production (Gross output)	Employment	Productivity
Argentina	1984	1993	148	76	195
Brazil	1985	1997	111	86	130
Chile	1990	1996	156	134	116
Colombia	1991	1996	116	111	104
Costa Rica	1990	1996	123	79	155
Ecuador	1991	1996	109	93	117
Mexico	1988	1993	149	117	127
Peru	1992	1994	117	108	108
Uruguay	1988	1995	103	75	137
Venezuela	1990	1995	95	98	96

Source: Peres and Stumpo, 2000, table 9.

economies of scale or other sources of higher productivity.²⁰ Measuring net job creation accurately is difficult, however, partly because over time the threshold is crossed that distinguishes small firms from large ones. The most refined study of net employment creation, using data from 1973 to 1988, showed no relationship between firm size and net employment growth.²¹ While this and other studies revealed that job creation rates are higher in small firms, so too are job destruction rates, an observation that also applies to developing countries.

A study of Taiwan, China concluded that small enterprises exhibiting higher productivity are most likely to achieve net employment gains.²² On the other hand, evidence for ten Latin American countries is inconclusive, as table 5.9 shows.²³ In general, productivity increases for the formal SME economy as a whole were associated with increased SME employment in some countries and decreased levels in others. In sum, no clear trend emerges at a global level to conclude that increases in SME productivity will lead to higher rates of employment growth. It depends upon what happens to output. There is little evidence, therefore, that the productivity gap will result in the decline of the small-enterprise sector over time. The question thus remains: How is it that small firms are not driven from the market by more productive firms?

Why aren't small firms driven from the market?

The most likely answer is that small enterprises do not compete directly with larger firms. Instead, they find advantageous niches for small firms. Kiosks for food and household goods that bring products closer to consumers are one

²⁰ Birch, 1979 and 1987.

²¹ Davis et al., 1996.

²² Aw and Batra, 2001.

²³ Peres and Stumpo, 2000.

example. Service activities, such as restaurants and vehicle repair shops, are another. In addition, the market may be limited and specialized, with small firms filling specific niches, often in clusters and/or as subcontractors for large enterprises. In these cases, competition takes place with other small, less productive firms. Finally, small and large firms often cater to different segments of the market. Even when they are ostensibly producing the same product, the attributes are most likely to be different: for example, the washing soap or cloth manufactured in small units has less of the luxury elements likely to appeal to high-income consumers.²⁴

When small firms do produce goods similar to those made by large firms, they often produce at lower quality levels, thus avoiding direct competition. In poor countries, there are large markets for low-quality but affordable goods purchased by the poorer sections of the community.²⁵

The implications of economic “dualism”

As discussed above, many developing countries are characterized by a rather strict cleavage between small, less productive firms and large, more productive ones. This can be taken as evidence of a “dualistic” economy, which is measured not only by differences in enterprise size but, as will be seen, also by differences in livelihoods and standards of living. Such “dualism”, moreover, is apparent also in industrialized countries. The classic example is Japan. Its dualistic pattern of industrialization has a long history, whose roots are in the initial conditions of labour abundance during Japan’s industrialization (which contributed to labour market segmentation) and the simultaneous development of a complex large industry, of the State and of financial conglomerates that accentuated capital market “dualism” (discussed below).

Some other less developed countries in Asia – India, Indonesia, the Philippines – all share with Japan the dualistic pattern in their modern (formal) manufacturing sector.²⁶ The productivity difference between the small and the large size-groups of firms is much larger in these Asian countries than in Japan. Thus, while the surplus labour situation in Asian countries causes the dualistic pattern to emerge in a wide variety of Asian economies, Japan had succeeded (by the mid-1980s) in narrowing the gap in productivity between small and large firms that typically characterizes dualistic development. Doubtless there are many explanations for this. An important one is likely to be the growing integration through subcontracting of the small-firm sector with larger firms – an integration that compelled the upgrading of efficiency and quality standards in small firms. This is an issue of policy relevance to which discussion will return.

²⁴ Little et al., 1987.

²⁵ It is also true that the statistics provided above are very general; many small enterprises (especially but not exclusively in developed countries) will achieve levels approaching those of large firms.

²⁶ It should be emphasized that the data sets considered here exclude very large household and other parts of the informal sector in establishments employing less than 5 workers.

Asian economies such as those of India, Indonesia, and the Philippines have in common a large labour force in household manufacturing units, which is slowly shifting to the non-household manufacturing sector. The lack of technical dynamism of the small-scale sector reflects its limited upward mobility, leading to the phenomenon of depressed relative labour productivity in small enterprises and the phenomenon of the “missing middle” – or the absence of intermediate-size establishments. All three economies have had their fair share of import-substituting industrialization, characterized by significantly sheltered domestic product markets, which was not particularly conducive to the dynamic growth of SMEs. As far as factor markets are concerned, evidence suggests that industrial and financial policies contributed to there being a marked degree of difference in access to capital: it was available at low cost to large firms, and either not available, or available at high cost, to small firms. The dual consequence of this was, first, to favour the use of capital-intensive techniques in the large-scale sector, and therefore to bias against employment creation there and, second, to curb the growth of small firms.

In short, the stunted growth of dynamism in the small-firm sector is both a reflection and a cause of the failure of greater integration occurring between a relatively unsophisticated small-firm sector and a more dynamic large-firm one. Narrowing the dualistic extremes results, among other things, from greater integration between small and large firms as, again, was likely a factor at work in Japan.

A large difference in levels of productivity and wages between small and large firms implies that the economic distance between the small- and large-firm sectors is wide. Policies designed to shift resources to the SME sector would seem to be called for. But merely increasing employment in the small-scale sector is not enough if wide productivity differentials with large firms persist. In a world of excessive underemployment, employment increase is not only a goal in itself; increasing decent and productive employment is. This would need to be accompanied by measures to reduce the economic distance between large and small firms. And this in turn entails a focus on increasing employment and productivity in SMEs at the same time.

5.4. Social dimensions of the productivity gap

The avoidance of direct competition may answer the productivity–employment question, but it remains true that small firms are producing less value added per worker. This affects the returns that such firms can pay to their owner(s) and their workers. *The concern with small enterprises is not specifically that they exhibit low productivity but that, because of low productivity, the wages they pay to workers and the income they generate for owners may not be sufficient to support a decent standard of living.* Owners and workers may be working but their work may not allow them to exit from poverty.

While low productivity can limit wages and income, it must also be recognized that low wages can limit productivity. This notion, known as the “efficiency

wage theory”, suggests that raising wages can have an incentive effect on the recruitment and retention of efficient workers and on their motivation within the enterprise. Raising wages to improve productivity will only work up to a certain point, of course, but can be part of a broad strategy to raise productivity. Indeed, different economic theories have demonstrated that wage growth restraint retards labour productivity growth.²⁷

The connection between wages/income and poverty is fairly direct. Poverty is partly measured in terms of material well-being, including such physical essentials as adequate food, clothing and shelter and is partly related to essential services such as education, water, sanitation and health care. The ability of a household to provide these essentials is based partly on its capacity to purchase them, partly on its capacity to self-supply them and partly on the receipt of services (at low or no cost) from public agencies. If, as shown above, small-scale activities account for the majority of income-generating possibilities for poor people, then such activities are most important in the struggle against poverty, because they allow the purchase of essentials and a more decent living standard.

Generally, both paid and self-employment will help to reduce the income aspects of poverty if they support:

- i) a move from underemployment and unemployment to employment;
- ii) a rise in the total wages and benefits paid to poor employees (including informal employees and family workers);
- iii) a rise in the income from low-paying self-employment (including the movement from underemployment to fuller employment);
- iv) a more general, long-term shift in an economy from lower paid informal, dependent or self-employment to better paid and better protected employment or self-employment.

In addition to insufficient income, poverty is also a condition in which people lack control over their lives and lack security about their future. These issues are closely related to aspects of decent work, notably workers’ rights and social dialogue (empowerment issues) and social protection. They can also have an impact on the productivity of enterprises both in the motivation and retention of workers and in the way that work is organized. This point is discussed below.

The wage gap

Because of the differences in labour productivity between small and large firms, wages are also different in these firms.²⁸ This is unsurprising as low productivity is likely to have an impact on holding wages down and, simultaneously, low wages can limit productivity, as discussed above. In interpreting wage data, it is important to recall that wages will tend to be lower for workers with fewer skills and less experience. Thus, wages may be lower generally in small enterprises if

²⁷ Naastepad and Kleinknecht, 2004.

²⁸ Mazumdar and Mazaheri, 2001.

they hire less qualified personnel, which owners tend to do. Dualism thus also implies segmentation in access to education and skills. Low wages can be explained wholly or in part, on this basis. Unfortunately, comparisons of wage differences between small and large enterprises do not usually account for differences in skills and experience.

Table 5.10, based on evidence from two Asian and two Latin American countries, confirms the wage gap. On average, wages in small²⁹ formal manufacturing enterprises are about two-thirds of the level found in large enterprises. Medium firms are closer, at four-fifths. Note that for more developed countries (Hong Kong, China and the Republic of Korea), the gap is narrower than for less developed countries (Brazil and Colombia). In Hong Kong, China wages in medium and large firms are the same. In all cases, the percentage gap between wages is less than the gap in productivity.

A similar wage gap can also be observed in Africa.³⁰ For example, wages in formal micro-enterprises in Ghana were one-quarter of those paid in large firms. The average monthly wage for micro-firms was slightly above the minimum wage, possibly suggesting that workers from micro-enterprises tend to escape the official poverty line. Similar results are also found in the United Republic of Tanzania.³¹

Given the difference in efficiency and wage levels when small and large firms are working in segmented markets, a reallocation of employment to

Table 5.10. Wage and productivity gaps, according to enterprise size, 1960-1980 and 1970-1989

Economy ^a	Years ^b	SME value added per worker as % of that for large enterprises	SME average wage as % of that for large enterprises
Brazil	1960-80		
Small ^c		56	64
Medium ^c		76	80
Colombia	1970-89		
Small		46	50
Medium		70	71
Hong Kong, China	1977-90		
Small		66	91
Medium		89	100
Korea, Republic of	1970-91		
Small		41	69
Medium		74	81

Notes: ^a No. of total observations for each country: Brazil 270; Colombia 360; Hong Kong, China 195; Rep. of Korea 360. ^b Observations for five years within the time period given in the second column. ^c Small = 10-49 workers, medium = 50-499, large = 500+.

Source: Weeks, 2002, p. 17.

²⁹ Here, small formal enterprises do not include micro-enterprises.

³⁰ Mazumdar and Mazaheri, 2001.

³¹ Goedhuys, 2002.

smaller firms (after markets become more integrated) might imply that SMEs will be forced to upgrade their labour quality. For example, if SMEs participate more extensively in export markets after a change in economic policy, they would need to be more selective in their labour recruitment and more intensive in labour training if they are to attain the quality of product and marketability required by world markets. This would tend to increase the wage level in such firms and reduce the wage difference with respect to large firms.

In order to understand the earnings and wages of small firms, it would be worthwhile to study the nature of small firms in developing countries and, indeed, small-scale activity generally. Very often, firms are of extremely small size in developing countries. These are micro-firms operating in the informal economy each of which has an owner, or a few helpers, who are usually family members.

Micro-entrepreneurs in the informal economy

Most enterprises in developing countries consist of very small, “survivalist” activities, operated mainly by poorer sections of the community. They exist alongside more substantial, competitive small enterprises, which generate greater returns for their owners. These differences will have a great bearing on the extent to which enterprise activities allow their owners to escape from poverty and achieve a decent standard of living.

An estimated 60 per cent of those earning a living in the informal economy are self-employed.³² Thus the micro-entrepreneur is often the sole person working for the “enterprise”.³³ The entrepreneur pays no wages as a result. Any increase in productivity will depend solely on the actions of the entrepreneur (possibly with the aid of family members) and will translate directly into household income. Any financial gain that occurs is shared not with outside workers but with family members. Critical decisions for poor households relate to the division of any gains between consumption, savings and re-investment in the enterprise.

Many micro-entrepreneurs start a micro-enterprise because they cannot find paid work. Being poor, they have very little capital, which forces them to concentrate on activities where investment and working-capital requirements are low.³⁴ As a result, a large number of poor people are drawn towards similar types of activities. Together, they generate an abundant supply of simple goods and services that keeps competition high and prices, sales and profits low. Nevertheless, many vendors and artisans are underemployed. They remain the whole day at their street stand or in their shops, selling very little but unwilling to produce more because they are already surrounded by unsold finished goods.

³² In some African countries, this figure rises to over 90 per cent (ILO, 2002, p. 20).

³³ Often the owners would not perceive their activities as bona fide “enterprises”.

³⁴ The productivity of the self-employed is affected by the capacity to invest in tools and goods. However, women typically have less access to and control over resources to support their work. Among the informal sector activities of the poor in Dhaka, Bangladesh, for example, women were more likely to be engaged in home-based activities “involving small amounts of capital which generate less earnings” (Salway, et al., 2003). On average, women owned less goods by value and lower valued tools and equipment than men. See also ILO (2004a).

Their poverty trap is reinforced; they lack the capital to engage in more productive, higher-value work and their lack of productive work limits the surplus they can generate to invest in their enterprise. This is one reflection of the poverty trap in developing countries where the effects of poverty then become its causes. The issue here is how to break this cycle of poverty.

As table 5.11 shows, a study of micro- and small enterprises in Kenya found that only 26 per cent of enterprise owners earned an income above the minimum wage.³⁵ In this situation, the implications for productivity are clear. With no employees or only some family members assisting, there is only a limited basis for increasing productivity through the better management or treatment of the work team. Intra-firm productivity questions relate to the entrepreneur's activities (how efficiently s/he works, how to invest in and manage tools, machinery, inventories, supplies, etc.). Productivity is low – not because work is organized inefficiently, but because there are no incentives and no resources to keep everyone working productively.

In evaluating the productivity of survivalist activities, it is important to recall that this activity may be part of a larger household “multiple livelihood strategy”.³⁶ Such a strategy involves general income from a variety of sources, including: food and cash crop farming, plantation labour, informal enterprise activity, homework/outputting, formal employment in enterprises, and migrant employment in other, richer, countries. A person may derive an income from two or more of these types of employment and family members may contribute income from different types of work activity. Women, because of domestic activities (child-raising, farm work), are more likely than men to take on multiple household activities, although not all may generate income. These roles often include micro-enterprise activity, although women with families are limited in their capacity to engage in such activities on a full-time basis.

Table 5.11. MSE owners earning above the monthly minimum wage, Kenya, 1995

Categories	Percentage of owners earning above minimum wage
All MSEs	26
<i>Gender</i>	
Male-owned	26
Female-owned	23
<i>Education</i>	
Primary or less	24
Some secondary or more	38

Note: MSE = Micro- and small enterprises with 10 workers or less.

Source: Daniels, 1999, p. 61.

³⁵ Daniels, 1999, p. 61.

³⁶ Bryceson, 2002; Carney, 1998.

Table 5.12. Contribution of MSEs to household income, Kenya, mid-1990s

MSE contribution to household income	% of all MSEs	% of urban MSEs	% of rural MSEs
All or almost all	24	49	15
More than 50%	17	14	18
About 50%	20	15	22
Less than 50%	29	14	34
Negligible amount	10	8	11

Note: MSEs = Micro- and small enterprises with 10 workers or less.

Source: Daniels, 1999, p. 61.

Research on Kenya highlights the existence of these livelihood strategies.³⁷ Only 24 per cent of micro- and small enterprises, mainly in the informal economy, provide all or almost all of household income, as table 5.12 shows. This aggregate figure hides important differences between urban (49 per cent) and rural (15 per cent) areas, however, as rural landholders have a greater opportunity to rely on food production to support consumption.³⁸

For households owning (or renting) land, important decisions about work are made on the basis of productivity and income-earning capacity. If enterprise activities are highly remunerative, then the best use of household labour may be to hire labour for farming and use household labour for non-farm activities. In Honduras, for example, the level of non-farm income contributes significantly to the use of fertilizers on the farms of poor households. This suggests that non-farm employment can raise the productivity of household farming activities and is an example of how farm and non-farm activities impact on each other (see also Chapter 3 of this Report).³⁹

Higher incomes for successful entrepreneurs

Many entrepreneurs in the informal, micro-enterprise economy generate a low but decent income, despite evidence of lower productivity. The research to date has tended not to focus on whether enterprise income is above the poverty line but rather on comparisons to a minimum wage (often a proxy for the poverty line) or with formal economy wages.

Research on Peru, for example, has shown that small formal enterprises were between 2.9 and 4.1 times more productive than informal enterprises in the same sectors, as confirmed in table 5.13. However, these differences were not matched by earnings differences of a similar magnitude. Informal entrepreneurs in several sectors earned about nine-tenths of the wages paid to formal-economy employees. In the transport sector, informal operators (notably drivers) earned

³⁷ Daniels, 1999.

³⁸ This opportunity is not available to the rural landless, of course.

³⁹ Ruben and van den Berg, 2001.

Table 5.13. Ratios of productivity and income, formal/informal, Peru, mid-1990s

Sector	Labour productivity Formal/informal	Informal income/ Formal wages
Light manufacturing	3.5	0.9
Textiles	3.5	0.9
Construction	2.9	0.9
Transportation	3.3	1.3
Commerce	4.1	0.9
Diverse services	3.6	0.9

Source: Kelley, 1994, p. 1400.

more than their formal-economy counterparts.⁴⁰ Workers may opt for informal activities if micro-enterprise earnings are likely to be higher than wages in the formal economy.

Comparative income data for Mexico indicate that the movement from formal wage employment to informal self-employment results in a 15 per cent *increase* in income.⁴¹ At the same time, the movement from formal wage employment to informal wage employment, in similarly sized enterprises, results in a 12 to 15 per cent income *decrease*. The results depend, in part, on the value of medical and social security provisions that workers receive (and pay for as a deduction from wages) in the formal economy. According to the study, many workers report that the health services are poorly delivered and consequently the health insurance deduction is a loss of income.

The evidence presented in these detailed studies and through the previous discussion regarding survivalist enterprises implies that it may be difficult to generalize about the income earned by SME entrepreneurs. Interventions to help owners lift themselves and their families out of poverty will need to be sensitive to these differences, as policies can easily assist the more successful rather than the poorer entrepreneurs. Box 5.2 explores the question of why SMEs should be subsidized.

Beyond income: The fuller dimension of poverty

While income is an important aspect of poverty, participatory research on the nature of poverty has expanded the frontiers of common understanding. Based on responses from 60,000 poor women and men in 60 countries, the research reveals the importance of political and psychological elements to human well-being.⁴² Most notably, these include perceptions of empowerment (control over one's environment) and security (ability to assure one's well-being over time). They are related to physical needs and income, but suggest a longer time frame and the ability and capacity to satisfy one's needs. Such aspects of poverty bear close

⁴⁰ Kelley, 1994.

⁴¹ Maloney, 1999. The comparison is with net formal sector wages (i.e. after deductions).

⁴² Narayan et al., 1999; World Bank, 2000.

Box 5.2. Do SMEs need to be subsidized?

Reviewing the literature on SME assistance programmes, one can find four economic rationales for subsidies:

- SMEs make special contributions to economic development and poverty alleviation (for example, job creation);
- Market failure creates problems for SMEs in accessing markets and raising technological capabilities;
- Institutional failure raises SME transaction costs, and limits their ability to take advantage of economic opportunities;
- If the two above elements were corrected, firms would need to devise different kinds of strategies, structures, and develop core technical capabilities to respond appropriately to the new market and institutional conditions. This requires considerable costs for the firms.

It is also often asserted that fostering the development of SMEs has beneficial political and equity implications. It is posited that increasing participation of SMEs strengthens dominant values and enhances political stability, thereby promoting economic development and democracy. Moreover, it is stressed that SMEs are owned and run by the poor; hence support for them improves the distribution of income.

In reviewing the rationales for subsidies to promote SME development, one arrives at the general conclusion that a good SME development strategy, first and foremost, is in reality a good “private sector development strategy”. However, that being said, there are several areas where a case might be made for selective subsidies.

- First, policy-imposed distortions in some cases may reduce the number of SMEs below efficient levels (i.e. cause extreme size irregularities in the distribution of firms) by imposing fixed costs that bear more heavily on small firms. Removing the policy distortions would be the first order of business in the presence of such problems. However, it is conceivable that a second-best approach, in extreme cases, would involve complementary subsidies to stimulate the formation of more small firms.
- Second, market failure, particularly in the areas of technology transfer, training, and finance often needs to be addressed in developing countries. Interventions to counter such problems, however, would generally be aimed at all firms. But some special size-related issues in these areas also need to be considered. Finance, for example, is a particular case where information and enforcement problems can lead to rationing of small firms from the market. Thus, in addition to programmes to improve financial market development, there may be a need for interventions to assist SMEs in overcoming information and enforcement problems in order to gain greater access to the market. Similar examples apply in the areas of technology transfer and training.
- Third, SMEs need appropriate institutions to prosper. In many developing countries, interventions may be helpful in building up the appropriate *one agency* that deals with small firms. However, as an efficient set of large enterprises is required to develop these appropriate institutional structures for small enterprises, assistance to large enterprises may also be needed to extend their institutional reach to SMEs.
- Fourth, even if policy-makers can effectively intervene with appropriate subsidies to correct market and institutional failure, it is not clear in all countries that SMEs have the prerequisites to respond to the new, subsidy-induced structure of incentives. Often their capabilities are too low, or the learning mechanisms available to upgrade their capabilities too weak to take advantage of incentives. In such cases, interventions should aim to strengthen the existing learning environment and to expand markets for business development services.

Source: Biggs, 2002.

similarity to elements of the ILO's concept of "decent work".⁴³ Along with the availability of remunerated, productive work, decent work includes rights at work, social dialogue and social protection. Fusing the two approaches provides the following additional poverty elements related to small enterprises and poverty:

- i) **Empowerment:** Workers are entitled to freedom of association, collective bargaining and a constructive dialogue with owners and managers on the conditions of work, remuneration and benefits. Empowerment also includes social dialogue at the tripartite level, which allows workers to advocate for better living conditions (health, education, housing, water and sanitation). It also allows the owners/managers of enterprises to dialogue with government on the policy environment.
- ii) **Security against income loss:** For workers, security derives in large part from access to social protection against illness, disability, unemployment, old age and the death of a main income earner. For enterprise owners, it also involves freedom from harassment by public officials, the right to hold private property and conduct business, and the right to freedom from expropriation by the State.

For these aspects of poverty, small-enterprise workers and their owners tend to be disadvantaged. The level of unionization is much lower in small enterprises and the rights of workers are often much weaker. This is partly related to the informality of the smallest enterprises, which operate outside of regulation by public authorities. The ILO's efforts to help these operators access the formal economy are aimed at this problem. Small enterprises also lack effective representation vis-à-vis public authorities. In employers' associations and federations, the concerns of small-enterprise members are often overwhelmed by those of larger enterprises. This is changing, however, as many federations have sought to embrace the concerns of small enterprises, and as small enterprises have gradually built themselves representative organizations.

Workers in small enterprises also have less security than those in large enterprises, notably in their access to social protection benefits, such as unemployment insurance, termination payments and health insurance (see, for example, an ILO study on the United Republic of Tanzania).⁴⁴

Such aspects of empowerment and security highlight the lower standards of non-income aspects of poverty. The ILO seeks to raise these standards, where possible, as a contribution to poverty reduction and the promotion of decent work. Like wage increases, non-wage improvements can also contribute to increased productivity. Box 5.3 describes the initiatives to raise productivity taken by the ILO's small enterprises support programme within the SEED (Small Enterprise Development) Unit.

⁴³ ILO, 2000.

⁴⁴ Goedhueys, 2002.

Box 5.3. The challenge of raising productivity: ILO/SEED's experiences with job quality

The ILO's small enterprises support programme, IFP/SEED, confronts the productivity challenge by focusing on improvements in work practices – what is referred to as “job quality”. It also emphasizes market access in an effort to reduce the problem of underemployment. The overall aim is to create a virtuous cycle in which job quality, along with market access, can raise productivity which can, in turn, result in better wages and income for workers and owners.

By focusing on the work organization aspect of productivity, SEED supports the global productivity movement – a broad approach to increasing productivity which emphasizes the conditions and organization of an enterprise's valuable human resources. It is based on respecting workers' rights, applying international labour standards (including health and safety) and supporting skill training. These changes can reduce work-time loss caused by accidents and injury and can increase the well-being of employees who are better motivated to contribute to enterprise performance. The approach underlines cooperative relations between workers and management, including discussions on the organization of production (such as the quality circle, where workers and managers regularly sit together to discuss how to improve production efficiency and product quality and reduce product defects). Cooperative work practices are designed to empower workers by reducing the distinction between management and labour and allowing the latter to influence production decisions. SEED's contribution to this movement has been to develop curricula for management training and to initiate public awareness campaigns so that the principles of raising productivity through job quality can be transmitted to small enterprises in the developing world.

SEED and productivity

SEED's work has focused on small-business management training. It has recently included social awareness campaigns to reach a large audience regarding the link between job quality/decent work and productivity. Other aspects of SEED's work also contribute to productivity, although not in as direct and focused a manner as the job quality activities. For example, SEED works with governments to create a more conducive policy environment for small enterprises and it works with specific sectoral and business associations to promote decent work and enterprise performance. Its work on market access attempts to increase the demand for goods and services produced or provided by small enterprises in an effort to reduce underemployment or raise the value of output. The full impact of SEED's work on productivity, therefore, is difficult to gauge. Its focus here is on the small-enterprise management training due to its specific goal of increasing productivity and the availability of impact assessments. Assessments are based on specific enterprises and demonstrate the challenge of raising productivity in small enterprises by improvements in job quality.

The ILO has carried out productivity-enhancing programmes in many different sectors in a number of countries. Examples include: improving cleanliness and employee relations in food processing (Ghana); shop-floor conditions and marketing in a brassware cluster (India); drum-making, drumming and driving: a multiple-livelihoods strategy (Trinidad and Tobago); building a kitchen in a small restaurant (Uganda); training workers in paper packaging (Viet Nam). These examples provide

(continued overleaf)

evidence of how the application of job quality can enhance the productivity of small enterprises. Demonstrating the precise impact of small-business management training on productivity is difficult because the training seeks also to support competitiveness and market penetration. While such training does influence the performance of individual enterprises and the lives of their employees, there is a need to expand the impact more broadly across sectors and throughout the economy. SEED's recent work on social awareness, the policy environment, sectoral activities and business associations plays a role. The effects of these activities are part of a wider effort to reinforce the idea that job quality is a key factor for productivity improvement, along with physical capital, skills and technological change.

Source: ILO 2003a.

5.5. Addressing the productivity divide

The heterogeneity of conditions under which small-scale economic activity occurs, from the informal economy street vendor to the dynamic small firm in the formal economy, makes the search for policy prescriptions a complicated one. For example, for many subsistence activities, the basics matter – access to infrastructure, to essential services, to education and health care, to freedom from discrimination – in short, the traditional development agenda. There are, however, other ways in which small firms can address their productivity disadvantage relative to large firms. Here, two organizational models are of particular interest: industrial “clusters” and cooperatives. Both are a means of mitigating the isolation and size disadvantage of the small firm. Both are also a means of generating higher productivity and thus more decent livelihoods.

Encouraging the “collective efficiency” of the small-enterprise sector

It has long been observed that some of the most traditional industries, such as garments, have been able to survive in otherwise high-cost environments (high labour cost and other high production costs), such as northern Italy. How this has occurred is largely a matter of industrial organization associated with the concept of “clustering”. Clustering refers to an agglomeration of small firms in physical proximity to one another in the same or related industries. The concept can be thought of as one that balances the competitiveness of the individual firm with cooperation among firms. In turn, this cooperation can be instrumental not only in increasing the efficiency of the individual firm, but also in increasing the “collective efficiency” of the cluster. Clustering is a means of overcoming the competitive disadvantages that confront small firms, acting independently, in relation to larger firms.

Clearly the major disadvantage small enterprises face is that they often lack the potential for economies of scale – that is, the ability to use their existing labour and machinery to respond to increases in demand. Their output thus

tends to be small. This, in turn, keeps both productivity and wages low. When groups of firms pool both their inputs (as noted below) as well as share demand in the market, they can achieve economies of scale to the benefit of profits, productivity gains, wage and employment increases.

Clustering can be considered as a means of increasing the productivity and competitiveness of small enterprises (and in so doing reducing the volatility of employment tenure) in two general ways:

1. *increasing the quality and reducing the costs of inputs*: when firms collectively purchase inputs, they typically negotiate a better price, which, in turn, is reflected in lower input costs. There are also advantages in sharing or pooling a number of other business needs. For example, firms could share the cost of training (and, indeed, share the local labour pool), which is a cost-effective way of improving skill levels and disseminating know-how.
2. *increasing the size of the market and reducing the cost of market access*: participation in commercial relations with larger firms is a means of gaining greater market access and thereby increasing output and profits. A common constraint in establishing large firm/small firm linkages is that the small firm lacks the capacity or standards of quality and delivery to service the large firm market. When small firms cooperate to obtain major orders, these constraints can be overcome, and a better price for the firms' products can be negotiated. The latter can occur because small firms acting together have greater "clout" and can also bypass one or several tiers in the value chain.

The foregoing description is necessarily only an outline. There are a host of ancillary advantages when an atomistic or fragmented competitive environment is overcome through clustering, such as access to credit markets on more favourable terms. The advantages, moreover, are not merely economic: they can be part and parcel of a participative local community development strategy.

In discussing clusters, it is appropriate to evoke a concept of "protected stability", since when small firms collaborate, they are better protected against the volatility or instability of markets. Poor groups may also have a particular gender, ethnic or religious composition that restricts access to the means of enhancing their position (see box 5.4). Box 5.5 presents ongoing work conducted by the ILO in assisting a woodworking cluster in Indonesia to meet the challenges of globalization.

The collective advantage of cooperatives

While the concept of clusters does not refer to an ownership structure, the concept of a cooperative does: a cooperative is a firm or a collective of firms, owned by their members, and involved in the production, distribution, or consumption of products. A common feature that cooperatives share with clusters is the organizational concept of overcoming the disadvantages of atomistic competition through a model of inter-firm cooperation.

Box 5.4. SME clusters: Working to reduce poverty

Clustering – or geographical concentrations of enterprises working in the same industry – can help SMEs compete in local and global markets. Cluster development also helps to reduce poverty, by creating employment, generating income and reducing vulnerability for small producers and poor workers. Two indirect effects on the local economy are creating secondary jobs and attracting service providers.

Numerous examples show small-enterprise clusters in developing countries successfully competing in global markets – from the shoemakers of Brazil's Sinos Valley to the garment producers of Tirippur and Ludhiana in India. Many such clusters began as informal networks in resource-poor regions and at early stages of industrial development. For such communities, clusters offered a gradual and sustained path to industrial growth.

Clustering and poverty: Conceptual links and empirical evidence

Conceptually, clusters and poverty are related in three distinct ways:

- **Cluster features:** Certain types of clusters can have a more direct impact on poverty. These include rural clusters and, in the urban informal economy, clusters with a preponderance of SMEs, micro-enterprises and homeworkers, clusters in labour-intensive sectors and clusters that employ marginalized and poorer groups of workers, such as women, minority groups, migrants and unskilled labour.
- **Cluster processes:** Agglomeration economies reduce costs and allow small firms to access markets, thereby raising the capabilities of workers and producers through income and employment. Cluster joint action can take such capabilities further by strengthening the capacity of local firms and reducing their vulnerability to external shocks. The presence of social capital can be critical here, strengthening trust and fostering collaboration. It can also contribute to informal social protection, easing the burden on vulnerable groups.
- **Cluster dynamics:** Cluster growth produces winners and losers among enterprises and workers, underlining the importance of processes of differentiation. For a poverty reduction agenda, it is critical to note which types of firm (and groups of workers) gain over time and which lose out.

Cluster development provides an important survival and growth opportunity for poor regions in developing countries – from rural artisan clusters that provide critical off-farm incomes to poor households and women workers (Central Java, Indonesia), to urban informal-economy clusters engaged in low-skilled and labour-intensive garment production (Lima, Peru) and vehicle repair (Kumasi, Ghana). Such clusters generate work and incomes for poor, often migrant, households. Moreover, the evidence is clear that producers and workers within clusters fare better in terms of well-being than those in non-clustered settings. In incipient clusters, small producers advance by taking small steps in coordination with others. This allows them not only to survive, but to grow. Local agglomeration economies are salient here, as has been observed in incipient and mature clusters (from rural Indonesia to the urban informal economy of Nairobi, and to the export clusters of Mexico, Brazil, Pakistan and India). Joint action is especially significant, for example, in assisting local producers and workers to confront external shocks. Cooperation through local institutions reduced the vulnerabilities of clustered producers in Sialkot,

Pakistan, and in the Palar Valley, India. Some evidence suggests that social capital in both these areas has strengthened cluster capacities, raising the well-being of local workers and producers. Despite these positive findings, it is also evident that cluster growth trajectories can result in differentiated outcomes. Local linkages often give way to external linkages as outside knowledge and know-how become critical to survival in global markets. Conflicts between the competing interests of large and small firms can become more apparent, with smaller producers often being squeezed. Finally, there are signs that particular categories of workers, especially women and unskilled workers, can lose out as clusters upgrade.

Source: International Development Studies, 2004.

Political thinkers have long suspected that worker ownership has collateral benefits for democracy.⁴⁵ Theorists have argued that participative ownership was a training ground for democratic citizenship and citizen involvement. Perhaps the best systematic evidence in support of this claim is a study⁴⁶ of three Italian towns with differing amounts of cooperative ownership. The two towns with a higher percentage of cooperative members have lower crime rates, lower rates of domestic violence, more social participation, better developed social networks, and higher trust in authorities. The town with the largest percentage of cooperative members is typically the one with the best of all these outcomes.

The foregoing advantages are not inconsiderable. But does broadened ownership of enterprises by workers, agricultural producers, or small businesses affect enterprise productivity? Do agricultural and small-business cooperatives measure up to conventionally owned firms? A study commissioned by the ILO draws conclusions on this after reviewing literature on farm and small business cooperatives and the relations of these ownership forms to productivity.⁴⁷ There are good theoretical arguments for and against a positive relationship between employee ownership and productivity. The results, as in so much of economic theory, appear to depend on the assumptions. But if the theoretical discussion is inconclusive, what does the empirical evidence show?

Most empirical studies (in the developed and developing world) have found that the combination of employee financial ownership together with the ownership right to business information and the right to participate in decision-making, have positive impacts on productivity and other aspects of firm performance. Worker cooperatives provide the full range of such ownership rights.

The cooperative exists for the use of its members. As such, it may act like a conventional company in generating large profits for its owner-members, which it then pays back to them, or it may sell inputs to its members at lower prices and buy outputs from them at higher prices, limiting its net margins or surplus (i.e.

⁴⁵ Logue and Yates, 2004.

⁴⁶ Erdal, 1999.

⁴⁷ Logue and Yates, 2001.

Box 5.5. Effects of clustering in the Indonesian woodworking industry

In recent decades, the role of micro-, small and medium enterprises (MSMEs) in employment generation and their important productive capacity has been increasingly recognized by policy-makers throughout the world. However, the potential role of MSMEs is often not fulfilled due to difficulties associated with their size and related difficulties in acquiring resources, maximizing productivity, achieving economies of scale, and gaining a competitive edge to access new market opportunities.

Wood furniture is one of the major manufacturing sub-sectors in Indonesia, contributing 1-1.87 per cent of Indonesian total manufacturing output and adding around 2.7 per cent to the total value of Indonesian exports overall. While these numbers may appear small, they are higher than the share of most other sectors. In 1999, this industry contributed 4.05 per cent to national employment in the manufacturing sector. At the provincial level, the furniture sector is the biggest contributor to the exports from Central Java, with 27 per cent in 2000 and 21.5 per cent in 2001 (according to the Industrial and Trade Office of Central Java), as compared with garments (13 per cent) and textiles (13 per cent).

The geographical distribution of clusters does not come as a surprise. Most are located near the source of raw materials (the Perhutani teak plantations) and have access to roads and ports. Furniture production is primarily a manual process which is labour-intensive. Except in the case of high-volume, mass-produced garden furniture, the process relies on simple technology and artisanal skills. Now, however, times are getting tougher for the industry. Jobs are being lost as the availability of good timber declines and as competition increases from other countries in the region. Globalization is a particular challenge for the independent small firm. For example, from the production perspective, the entry barrier to the woodworking industry is very low. However, the barriers for production firms to enter the export market appear to be significantly higher – investments are steeper, the capabilities needed by management are greater, and it is challenging to establish direct linkages with international buyers, particularly as a first-time exporter.

With the assistance of the ILO, which has undertaken a study of the industry's global value chain, the Central Java timber furniture sector is changing: small and medium enterprises have begun to move away from operating in isolation, by way of linkages with other firms in close geographical proximity – that is, through the establishment of informal clusters. Through greater inter-firm collaboration, small, independent firms can gain greater leverage over global product markets, facilitating their entry into those markets. For example, through clustering, small and medium firms play a more supporting role in the production process, subcontracting to each other so that as a group (or cluster) they can jointly fulfil contract orders. Aside from efficiency gains, such a collaborative approach can pave the way for easier access to new technologies, sharing skills, greater in-house innovative capacity, and new product design capabilities – the results of which are higher value-added activities and a more stable market presence.

Source: ILO, 2004b.

profits) to the minimum necessary for the continuation of the cooperative. When the value added per hour worked in the cooperative is combined with value added by member in farms or enterprises, it may equal or exceed the value added by conventional farms and firms.

The issue is whether productivity is being measured at the level of the individual (cooperative) firm or whether, on the contrary, it is the productivity of the group of firms which is being evaluated. Empirical studies of productivity in individual cooperative firms have found mixed results. Some find that cooperatives have a modest performance edge. Others find that investor-owned firms have a modest performance edge. None takes into consideration, however, the impact of the cooperative on members' productivity.

From the empirical literature, it would seem that farm and business cooperatives have a net positive impact on value added per hour worked when both the individual firm and other member firms of the cooperative are included in the analysis. Indeed, cooperative advocates argue that members join cooperatives precisely for the productivity benefits, so the fact that cooperatives exist establishes that members perceive a benefit. By contrast, conventional economics offers robust analysis of firms only at the individual level, by factoring out externalities like benefits to members in the form of higher prices for their outputs or lower prices for their inputs. Missing in such analyses, therefore, are the *collective* advantages of inter-firm collaboration.

As Chapter 1 of this Report observes, the availability of alternative employment is a factor distinguishing developing from industrial countries. This, in turn, begs the question of how to balance the twin objectives of productivity and employment growth. For people who are largely unemployed, any regular employment makes them more productive than they otherwise were. There is, after all, no productivity in an unemployment line. Since people in developing countries cannot afford to be unemployed, they take up any available job. They are usually underemployed and their working conditions do not fall into the category of "decent employment".⁴⁸

Under these circumstances, the self-help, bootstrap aspect of the cooperative has substantial appeal in developing countries. Cooperatives facilitate people in pooling their greatest asset – their labour – along with small amounts of cash (perhaps all the cash they have), to create a larger enterprise from which they will receive a benefit and return. Under such conditions, the cooperative's members can gain a foothold in the economy, which is another step forward towards economic progress.

As observed above, moreover, there are substantial collateral benefits to cooperatives which may be unrelated to productivity but which are clearly related to the ILO's Global Employment Agenda.⁴⁹ If anything, these benefits are likely to be stronger in the developing world and among marginalized

⁴⁸ ILO, 2003b.

⁴⁹ *ibid.*

populations in the developed world than in the rich and middle class of the developed countries. They include:

- sufficient economies of scale to make otherwise inefficient small-scale production sufficiently productive in value-added terms to yield higher living standards for the owners and workers of small firms (or small-scale farmers and artisans) and to keep them from joining the ranks of the unemployed;
- the personal and community benefits that accrue from self-organization and bootstrap development – in effect, cooperatives are schools for learning the benefits of collective self-reliance;
- the development of transferable leadership and basic financial skills in poor communities; and
- the likelihood that members of one successful cooperative venture will attempt other cooperative efforts, such as adding a credit union to a successful dairy cooperative, or working with other groups outside the cooperative.

Cooperatives have historically emerged from market failure, from producers' inability to market their crops efficiently, or struggles with monopolistic and exploitative intermediaries. Generally speaking the existence of a cooperative as an alternative mechanism for purchasing and marketing helps to redress those market failures by introducing an element of cooperation and competition, as discussed above. In this way (even for non-member producers), cooperatives increase the efficiency of the market above what it would be in their absence. Last but not least, they increase the income of their members to above what they would earn and own in the absence of cooperatives. Broadening the distribution of income and the ownership of wealth among working men and women improves their life chances and, by improving their economic status, expands their realm of choice and freedom.

5.6. Concluding remarks

Small-scale activities and small firms are important in creating employment and they therefore hold an important key to reducing poverty in developing countries. Despite their handicaps, they are able to survive by operating in different markets as opposed to larger firms. They are clearly instrumental in the reduction of poverty. However, small-scale activities and small firms are less productive compared to larger firms and provide less favourable working conditions to their workers or family members. This productivity–poverty trap limits the potential of increasing the living standards of millions of people.

Because small-scale activities and firms operate in very different environments and settings, one simple policy to shift resources towards small firms will not suffice. Increasing employment will not lead to increasing productivity. These types of activities and firms should be better integrated within the broader economy. What is required is creating decent employment in terms of decent wages, better representation of workers or owners towards public authorities,

and better security in terms of social protection and health insurance. This can be achieved by the collective organization of such activities using two avenues.

1. Clustering – bringing together small firms in a specific physical location and providing them with the necessary infrastructure and services. This in turn will lead to the increase of collective efficiency and thereby overcome the problem of competitive disadvantage.
2. Promoting cooperatives – which are owned and operated by their members.

Governments should look seriously into the cluster concept in order to provide a conducive environment for small firms to develop through productivity gains. This will lead to better working conditions and reduce poverty by generating employment. The other much older concept of cooperatives should not be overlooked by governments if they want to increase productivity in small firms. These two policy issues are particularly relevant to developing countries.

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