Introduction

The research on productivity and employment in small enterprises reveals three interesting characteristics. The first is that productivity tends to rise with enterprise size; that is, small enterprises are less productive than large ones. The second characteristic is that small enterprises[1] constitute an overwhelming proportion of all private sector establishments and normally employ 45 to 65 per cent of the workforce. They are an important source of employment in both developing and developed countries. Thirdly, wages are lower and workers' rights and conditions are less adequate (i.e. job quality is lower) in such enterprises. Taken together, these characteristics indicate that a significant portion of the labour force in many countries is employed in small, low-productivity establishments, where workers earn lower wages and have fewer rights than workers in larger enterprises.

This depiction of small enterprises throws up several important issues, which we can organize around a question, a concern and a challenge. The *question* is: why are inefficient enterprises not forced out of the market by large, more productive firms? This should happen according to the natural process of economic competition. The survival of these firms raises an important *concern*: that poor wages and working conditions, linked to lower productivity, may not be adequate to support a decent living. In many poor countries, but also in developed countries, people may be working but still be unable to move out of poverty. This concern raises an important challenge for those interested in reducing poverty through decent work. The *challenge* is to find ways to link productivity improvements with decent work in a virtuous cycle. In this cycle, enhanced productivity would lead to better wages, benefits and working conditions, while better working conditions, achieved through effective labour-management cooperation, social institutions and a broader process of social dialogue, would support higher productivity.

The present paper is organized around these three issues. The question is dealt with in the first section. The most probable answer is that small and large firms continue to exist side-by-side because they often do not compete directly. Very small firms, notably those in the informal economy, however, tend to be forced from the market through competition and through the offer of better employment elsewhere as the economy develops. The concern is analysed in the second section, where our review of the evidence regarding wages and working conditions reveals that job quality is lower in small enterprises. In many cases, people are earning below the minimum wage. We find a diversity of experience among enterprise owners, however: some are poor while others earn more than they would as formal sector employees. The challenge is considered in section three. Here we suggest how productivity and improvements in wages/working conditions can be encouraged together and may be supported by training and effective social institutions. The main focus is on SEED's job quality activities with examples from case studies.

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

Much of the research on productivity is based on a single indicator: labour productivity. This measure is relatively easy to calculate and is practical in the sense that it allows for comparison across time and between countries. It is not the best measure,

[1] Unless indicated otherwise, the term 'small' in this paper groups enterprises normally classified as micro, small and medium. The actual size of such enterprises varies according to country definitions.

however, and while its deficiencies may not pose grave concerns in general cross-country comparisons, they do pose a particular problem in comparing large and small enterprises.

Productivity is the 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. In either case, the ratio between the value of output (quantity and quality) and the value of inputs has increased. When data are available for all inputs, then 'total factor productivity' or TFP can be calculated. Due to its inclusiveness, this is the most complete measure. It is often difficult to record all inputs across a sector or an economy, however. Instead, the main inputs can be used to calculate 'multi-factor productivity'. The KLEMS measure, which includes capital, (K), labour, energy, materials and services, is one of the broader multi-factor measures (Schreyer and Pilat, 2001).

Labour productivity, the most common indicator, is a single-factor measure. It results from a calculation of value added (output less intermediate or 'component' inputs), divided by the amount of labour used.[2] It is also called 'value added per worker'. Despite its name, labour productivity increases when value added rises through the better utilization, coordination, etc. 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, anything that raises value added will raise labour productivity. The term is therefore correct in that any change that increases value added makes workers more productive, but it is slightly misleading in that it denotes productivity in general, not specifically relating to workers.

Why is this understanding of labour productivity important and how does it relate to other issues such as poverty? A productivity increase allows for greater returns on 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. But if the increase in labour productivity arises from the use of additional machinery, then the gains will need to pay, at least in part, for this machinery. This means that enterprises with high capital investment are obliged to have higher labour productivity because they need to pay for the additional capital. Statistics that compare the labour productivity of large firms with that of small firms (which normally exhibit lower capital investment) contain a systematic bias.

There is another bias in the empirical research. Much of the work focuses on data gathered from industrial censuses or surveys of manufacturing firms. Manufacturing is much more affected by economies of scale than service activities. A large proportion of small enterprises are engaged in services, notably trading but also catering, repair work and personal services. The extent to which these two biases affect the data is not known and requires further research. Despite the limitation of 'labour productivity' as a measure, it is used in this paper because much of the evidence reviewed is based on it.

1. Why are small enterprises not driven from the market?

This section reviews the evidence concerning the productivity gap between small and large enterprises. It considers the existence of a gap in a static sense (a snapshot) and contrasts this with the important role that small enterprises play in providing employment. The issue of whether employment shifts from small to large enterprises over time is also

[2] Or more correctly, the number of hours worked.

considered. The question in the title is answered with the suggestion that small enterprises survive by avoiding direct competition with large firms.

1.1 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 1 indicates that the productivity of formal SMEs[3] in ten Latin American countries ranges from one-quarter to three-quarters of that for 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, with productivity rising through five firm-size categories (see Annex, Table A1). There are anomalies, though, with lower productivity in the largest size category relative to the second largest for Kenya, Cameroon and Côte d'Ivoire. This is probably due to a large number of state firms in this category. Figures for four Asian countries, including Japan, again show a very consistent pattern of labour productivity rising through ever-larger size categories (Table A2).

1.2 Employment role of small enterprises

Despite the labour productivity gap between small and large enterprises, it is also apparent that small enterprises constitute an important part of the economies of developing (and developed) countries in terms of employment and, to a lesser extent, output (Table A3).[*] Formal SMEs account for 17 per cent of total employment in low-income countries, rising to 57 per cent for high-income countries (Ayyagari et al., 2003, p.10). The shift is mostly accounted for by the decline in informal and agricultural employment that occurs as countries develop. Even in the manufacturing sector, where economies of scale would tend to favour large firms, SMEs provide an important source of employment in both high- and low-income countries. In Latin America, they account on average for 46 per cent of formal manufacturing employment and 32 per cent of output (Table 1). In countries as diverse as Ghana and Japan, 53 per cent of manufacturing workers are employed by enterprises with less than 100 workers (Mazumdar and Mazaheri, 2001, p. 35; Mazumdar, 1998, p. 47).

In addition, a significant portion of the labour force in low-income countries works for or owns/manages micro enterprises in the informal sector. This sector accounts for 29 per cent of total employment in the low-income countries and 15 per cent in high-income countries (Ayyagari et al., 2003, p. 10; see also Table A4).[*]

Combining the productivity and employment figures, we find that many workers in the developing (and developed) world are employed by enterprises with relatively low labour productivity. This prompts the question: how do small enterprises survive?

[3] Formal small and medium enterprises (SMEs), not including micro firms.

[*] Sources often vary considerably according to the definitions used, notably regarding the inclusion of the formal economy and whether employment is considered as a proportion of total employment or only non-agricultural employment. See, for example, the figures provided in Tables A3 and A4.