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GERMAN DEVELOPMENT INSTITUTE

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Promoting the Private Sector for Employment and Poverty Reduction - a Central Task of Development Cooperation

- *The last two decades have experienced hardly any improvement in the indicators for employment and poverty in the developing countries. Progress can be made only with an economic policy that creates the conditions required for economic growth centered on the private sector and at the same time seeks to facilitate the participation of insufficiently integrated population groups in techno-organizational learning processes and their functional incorporation in differentiated, specialized, and competitive economic sectors.*
- *Economic growth creates jobs, unless growth rates are so low that they are cancelled out by growth in productivity. Growth also benefits the poor, whose incomes normally rise in parallel to economic growth rates. However, growth does not automatically contribute to overcoming the segmentation of labor markets, raising the productivity of the informal sector, and incorporating it into the modern sector of a national economy. What is called for are therefore concepts aimed at a more inclusive pattern of growth.*
- *Under the conditions of increasingly open markets, sustainable economic growth can be achieved only by a competitive private sector. For this reason alone there is no goal conflict between a competitive orientation, full employment, and poverty reduction. Moreover, the world's highly developed economies show that small enterprises can ensure national competitiveness and innovativeness while at the same time creating jobs. This does, however, presuppose that the businesses in question focus on complementary tasks in the production systems, be it as specialized service providers, component manufacturers, or providers of niche products.*
- *Without promotion of the private sector development cooperation will be unable to fulfill sustainably its task of reducing poverty in its partner countries. It would, however, be wrong to assume, as is often done, that economic promotion achieves its optimal poverty-reducing impacts when it is brought to bear directly on traditional small-business activities engaged in by poor target groups. Most of these activities hold out few prospects for further development. Greater, and above all more sustainable, employment and poverty effects can be reached if promotion of the private sector helps given branches of industry to cope with the ongoing process of structural change by encouraging company-level competitiveness and the development of efficient forms of intercompany specialization..*
- *Development cooperation can better contribute to improving the framework needed for economic growth by more consistently keying funds to the criteria set out by the German Ministry for Economic Cooperation and Development (BMZ) for framework conditions conducive to development as well as by according high priority to high-level advisory assistance. In addition, it would be important to gear economic promotion to medium-sized businesses that hold out promise for the future, e.g. service providers in the fields of IT and logistics, suppliers, and exporters whose innovation and specialization generate positive externalities for the national system of production and services.*

More jobs, higher incomes: What promotion of the private sector is expected to accomplish

The employment and income situation of developing countries has hardly improved at all in the past two decades. While the percentage of the poor population in developing countries earning less than 1 US-$ per day has declined from 28.3% in 1987 to 24.0% (1998), unemployment rates and above all the share of precarious, informal jobs have been stagnating at a high level. In addition, the aggregate figures conceal great disparities in regional development (see box).

Poverty and unemployment: Regional disparities

There are substantial regional disparities to be found in the poverty and labor-market indicators. These indicators showed marked improvement above all in Southeast and East Asia in the 1980s and 1990s. In Latin America and in Africa the poor share of the population continues to stagnate, while unemployment rates and levels of informal employment have increased. The poverty and labor-market data reported by the successor states of the Soviet Union have been showing clear signs of deterioration. In all of the major regions named a significant share of the population remains largely excluded from economic and social development. The population segments hardest hit include young people, the elderly, unskilled workers, and ethnic minorities. Women are disproportionately represented in each of these groups.

There are four principle reasons for the alarming situation in labor markets. First, the active population continues to grow. While the annual growth rates in the developing countries do show signs of decline - from an average of 2.0% in the 1980s to 1.6% in the 1990s - in many countries in Africa, South and Southeast Asia, the Middle East, and the poor countries of Latin America the rate of growth is still over 2.5%, or sometimes even 3.0%. Second, economic growth has - with a few noteworthy exceptions - been low in the past two decades. Taken together, all developing countries shared an average growth rate of 3.0% in the 1980s and 2.8% in the 1990s - rates that just exceed the growth of the active population. Third, in some years labor productivity has grown more rapidly than output - in particular in the more functionally specialized sectors of the economies in question - with the consequence that the demand for labor has been declining in these sectors and showing a tendency to focus on certain well-trained population groups. Fourth, government reform and budget deficits are forcing most countries to cut employment in the public sector.

What is called for is therefore concepts for an economic development that leads to more employment and higher incomes that reach poor population groups as well. In view of the setbacks experienced by economic strategies of a statist and protectionist stamp, including the import-substitution strategies familiar from the 1960s and 1970s, the consensus today is that economic development must proceed from the private sector and seek its orientation in the competitive conditions typical of largely open markets.

What follows will plead for a model of *inclusive economic growth*, arguing that it is impossible to achieve any significant improvement of the employment and income situation without economic growth. It should, however, be noted that only very few developing countries have reached growth rates sufficiently high and stable to significantly reduce unemployment, the share of precarious informal jobs, and poverty. Since the internal and external conditions required for dynamics of this sort are not given everywhere, there is little point in attempting to use growth-conducive economic policy as the *sole means* of coming up with solutions to these problems. There is in addition a need for specific measures geared to creating a more inclusive pattern of growth. The main concern here is not socially motivated redistribution but the goal of enabling the workforce to participate broadly in economic development in the formal sector. This calls for additional investments in education and training as well as in startup programs and programs designed to promote the transfer of knowledge.

Employment and income effects of economic growth

Economic growth is the *sine qua non* of new jobs and higher incomes. Excepting the downturn linked with the 1997 financial crisis, the newly industrialized countries (NICs) in Southeast Asia have demonstrated impressively, some of them for decades, that high economic growth can lead to significant decreases in unemployment, considerable rises in real wages, and in this way to a marked decline in poverty. In other regions as well, the employment and income indicators have especially improved in countries which have achieved high growth rates (e.g. Chile, Mauritius, Ireland).

Growth as a rule also benefits the poorest population groups. For 80 countries, the World Bank indicates that in the past four decades the incomes of the poorest 20% of the population have on average risen in a ratio of 1 : 1 to growth of GDP. Despite ongoing globalization, this was also the case in the 1990s. The trickle-down effects of economic growth do, however, differ substantially from region to region. In Latin America in the 1990s, for instance, moderate growth of 3.2% failed to contribute to improving the situation in the labor market and to reducing poverty. Here the pronounced process of income concentration familiar from the past continues apace, and here the benefits accruing to the poor from economic growth are disproportionately low.

In developing countries labor markets and company structures typically show clear-cut segmentation (see box). Economic growth is generated mainly in the formal sector, though it also benefits the informal sector via two mechanisms:

- Growth raises the demand for goods and services from the informal sector. The by far greatest share of aggregate demand stems from the formal sector, and it is for this reason that income development of persons active in the informal sector is closely linked to the business cycles in the formal sector.
- Growth facilitates the transition from informal self-employment to regular employment. Some Asian countries with good growth figures have shown that high demand for labor in the formal sector can, with the exception of a few tenacious pockets, on the whole dry up the informal economy. This, however, presupposes very high growth rates over the long term.

Segmentation of labor markets and company structures

The segmentation of labor markets expresses itself in the fact that only a small percentage of the active population has access to regular employment with social insurance or some other type of job security. The rest of the active population is forced to work under precarious conditions, with many people creating their own jobs. The labor productivity and incomes typical for this sector are far below those encountered in the formal sector of the economy. In Latin America, for instance, where the labor markets are monitored in regular household surveys, the average incomes in the urban informal sector are 50% of those found for the formal sector.

This segmentation of labor markets is mirrored in company structures. The productivity gap between small and large companies is far greater than in the industrialized countries. This phenomenon is referred to as "structural heterogeneity". In effect, the informal sector contributes little to GDP, even though it employs a large percentage of the population. Most such countries lack dynamic medium-sized enterprises; there are hardly any functional linkages between the traditional informal sector and large - often transnational - corporations.

Yet even in the best case economic growth takes considerable time to make inroads into the segmentation of labor markets and business structures typical of developing countries. Empirical studies on the development of small informal businesses have found that the latter hardly ever develop into modern, specialized and integrated medium-sized companies, or indeed large corporations. The United Nations Economic Commission for Latin America and the Caribbean (ECLAC) has presented data indicating that the productivity gap between formal and informal businesses even shows a clear tendency to widen. When the formal business sector expands, this is for the most part due to diversification investments made by existing companies, inflows of direct foreign investment, or new business startups initiated by highly qualified persons. Cross-sectional evaluations confirm that donor-funded promotion programs also mostly fail to give traditional small and microenterprises the boost they need to develop into efficiently organized medium-sized companies.

Inclusive growth patterns

Since only a few countries display the rates of economic growth needed to significantly lower the number of persons who are unemployed or holders of precarious jobs and to overcome the structural heterogeneity of company structures, the only promising approach is *to make the pattern of growth more inclusive*. “Inclusive” means that a growing share of the active population will find employment in functionally specialized companies of the formal sector, and will do so under reasonable and appropriate conditions (e.g. social insurance, compliance with minimum standards specified by labor law). This means more than redistribution and income effects that gradually trickle down into the informal sector. A development pattern may be termed inclusive if its broad thrust is in the direction of a specialized, integrated national production *system*, i.e. if it succeeds in functionally integrating marginalized economic sectors with the dominant sectors, in this way narrowing down productivity differentials. Inclusive growth also has a social and a political dimension. Those who, in the long term, remain outside the dominant economic sectors are not only faced with economic disadvantages, they tend also, as marginalized persons, to have less influence on the composition of political decisions.

Inclusive development presupposes social learning that enables a growing part of the workforce to participate productively in processes of structural change, breaking down the knowledge divide separating marginalized population groups from those successfully active in the market. True, simple activities, for instance in labor-intensive agriculture or the contracting industry ("maquiladoras"), may provide income sources covered by social insurance benefits for some marginalized population groups; but a growth pattern based principally on such activities can quickly take on an exclusive character when labor-saving production methods are developed and introduced. The more complex societies become, the more the knowledge factor becomes a key competitive advantage tending to cancel out traditional advantages rooted in factor costs (e.g. wage costs). High productivity and high real incomes can be attained only by creating a knowledge edge in specialized fields and maintaining it by means of continuous innovation and productivity-boosting measures.

Competitiveness and inclusive development: The one does not rule out the other

Becoming competitive in largely open markets is a difficult process. It is for this reason that trade liberalization inevitably entails a process of structural change which will mean rationalization and, for some companies, bankruptcy and the job losses this entails. Local companies will in part be crowded out by global players. Efforts geared to international competitiveness are therefore sometimes seen - German development cooperation not excepted here - as incompatible with the goals of poverty reduction and job creation. Two things must be pointed out in this connection:

- Companies not geared to international standards cannot survive without recourse to protectionism. This lowers their incentive to innovate, which as a rule means that they will lag even further behind the international competition - unless instruments of industrial policy are used to narrow the gap, an approach which has seldom met with success. Protection of inefficient enterprises leads to suboptimal resource allocation, and the high costs associated with it entail additional burdens for consumers and taxpayers.
- Leading industrialized countries have shown not only that small and medium-sized enterprises (SMEs) are job creators, but that they also enhance the competitiveness of the industries in which they are located.

It should be noted, though, that SMEs in industrialized countries have characteristics that differ from those typical of developing countries. In *highly industrialized economies* SMEs perform specific functions complementary to those of large corporations. Every large corporation surrounds itself with specialized component manufacturers, engineering offices, and other service providers. This applies for classical industries like automaking, shipbuilding, electronics and in particular for the new information and communications technologies (I/C) that, since the 1990s, have become one of the engines of the world economy. The continuing upswing in the U.S. economy is based in large measure on productivity growth in I/C technologies that strongly impact all other manufacturing and service sectors. One of the striking features of the I/C industry is the unparalleled level of interaction in it between innovative startups and large, globally active corporations. The latter specialize in core areas, shedding certain other functions that are transferred to independent firms. Many big corporations generate more business ideas than they themselves can develop to maturity, and may promote and participate in startup companies which work further on these new ideas (and which they may buy back at a later time). This is how integrated production systems come about that combine the best features of small companies - specialization, flexibility, close customer relations - with the economies of scale enjoyed by large corporations.

This kind of integration is no more than weakly developed in most *developing countries*. What is typical for them is segmented company structures in which SMEs account for a large share of employment, but not of value added. In addition SMEs here are not integrated as functionally specialized units within a national network of industry and services, and large corporations are linked up with only a small number of SMEs. The by far greater part of SMEs manufacture simple standardized products and services in competition with large companies (clothing, shoes, food, furniture, retail items). Such SMEs are hardly represented in the export sector. Nor do they exhaust the potential for development and employment offered by new, knowledge-intensive services.

Causes for the low development potential of the informal sector

In developing countries, most new SMEs are born out of an emergency situation: for insistence, a person unable to find employment in the formal sector decides to try his or her hand as an entrepreneur. Such startup companies in most cases lack both substantial initial capital and sufficient business-related and specifically technical know-how. They are for this reason able to advance only into business fields that do not pose high financial and technical access barriers. These include for the most part low-quality goods or services for low-income customers. Since these business fields attract many jobseekers, these markets are marked by permanent oversupply. The profit margins - and thus also incomes and investment potentials - remain low.

In most developing countries the industrial structure of the private sector, the form and the depth of functional intercompany specialization, are thus largely out of step with the demands of an open, competition-oriented world economy. It is consequently essential to build a modern, functionally specialized SME sector as a means of ensuring that the overall system is competitive and innovative and will be able to do its part in creating new formal-sector jobs.

Since full employment, higher incomes, and poverty reduction are not attainable without economic growth, a poverty- and employment-oriented economic policy must start out by improving the framework for growth. Economic policies conducive to growth include a consistent stability orientation in monetary and fiscal policy, a gradual liberalization of foreign trade and capital and goods markets, privatization and/or modernization of public enterprises. Many countries have made good progress with such reforms in connection with structural adjustment programs, and it is reforms of this kind that create the conditions needed to build an efficient private sector. The World Bank has indicated that there is a distinct and positive correlation between the implementation of such pro-growth policies and the income development of the poorest 20% of the population.

Yet such reforms are themselves not sufficient to master the process of structural change needed in the private sector, to overcome structural heterogeneity, and to develop inclusive growth patterns. What is needed here is a state sector that is able, in dialogue with the private sector, to recognize the general direction in which the process of economic-technological structural changes is headed, to devise a national adjustment strategy compatible with the specific social development goals envisioned, and to implement this strategy with the aid of appropriate regulatory and promotion measures. It is here that we encounter one of the errors of structural adjustment programs of a neoliberal stamp: they subscribe to a theory of efficient factor allocation via self-regulated markets and therefore aim at scaling down rather than reforming the state.

Tasks of development cooperation

In view of these considerations German development cooperation is in need of a dual strategy. In the first place, it should focus more on improving the framework for economic growth. This means first of all that the BMZ criteria for framework conditions conducive to development, including creation of a market-friendly economic system and institutionally guaranteed legal certainty, should be used more consistently as yardsticks for the deployment of funds.

Furthermore, development cooperation should focus less on isolated local projects than on high-level policy advisory services. The diverse array of Germany development institutions offers the possibility to provide both general policy advice focusing on models and democratic processes and consulting services in specific policy fields. One important factor here would be to reach agreement on a common model in the sense noted above as well as on a clear-cut division of roles between the institutions active on the German side, in particular between BMZ, GTZ, KfW, DEG, DSE, and the political foundations.

In the second place, promotion of the private sector should be consistently geared to enable partner countries to come to terms with the process of structural change, strengthen their competitiveness, and ensure that more economic agents find access to the dominant production system. While it is true that this type of economic promotion does not directly target the poorest population groups, seeking instead to strengthen potentials, it is sustainable and thus contributes better - not least due to its linkage and demonstration effects - to attaining the goals of long-term poverty reduction. On the contrary, many development projects which directly target underprivileged groups - e.g. poor inhabitants of rural regions, youths, migrants – trying to upgrade their traditional economic activities, have failed for not taking the ongoing structural change into consideration. What is needed is not incremental improvements in small trade or the small-scale production of traditional mass goods - since these activities have little chance of surviving the impending process of industrial reorganization - but development of sustainable structures, e.g. to make it possible for companies to find their place in a new logistics network structured by supermarket chains, to promote business startups in the fields of information, communications, and other new services, to develop innovative products and build nontraditional exporting industries. SMEs should be seen not as a "social sector" but as a central element of a functionally specialized and competitive business structure.

If an effective medium-sized industry is to be created, it will be necessary to dismantle a great variety of economic, political, and cultural barriers which constitute impediments to the participation of some of the active population in modern forms of functionally differentiated economic life. Here general education and training can provide their contribution by ensuring more equal opportunity and social permeability. In addition, there is a need for measures designed to improve access to credit, to simplify the administrative procedures needed to start up new businesses, to dismantle market reservation, and to more effectively enforce legal claims.

In addition, economic promotion should, as is usual in the OECD and some Asian NICs, be focused on promising companies in new economic activities, in order to provide them with support to cope with structural change, concentrating above all on:

- *Innovative companies*. These deserve to be supported in particular in that they develop new growth industries, hold out prospects of high incomes (innovation rents), and can, thanks to their model function, help advance the modernization of other companies. To support innovative companies, it would be necessary to develop a set of specific instruments, including venture-capital funds, technology and startup centers, business-plan competitions, and incentive systems at universities and colleges that stimulate cooperation with industry.
- *Production-supporting service providers* in fields like logistics, quality management, software development, and telecommunications. In addition to supply-side policies, a promising area would be programs that temporarily subsidize the use of such services, in this way contributing to the development of a private market of production-supporting services.
- *Suppliers*. Some countries have shown that supplier relations can play an important role in integrating production chains and facilitating technological learning in SMEs. Supplier policies are most effective if they specifically target a select number of promising companies and actively involve customer firms in the support schemes.
- *SMEs with export potential*. Exports can be an important engine of growth, though this option is often reserved for a limited number of large companies. With an eye to ensuring a more inclusive export development, it is important to identify and promote SMEs with unexhausted export potentials, and to encourage them to organize in export pools. Such firms would include efficient companies active in the domestic market, occasional exporters with expansion potential, exporters to regional markets who could expand to third markets, and suppliers who are already exporting indirectly.

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