

THE INFORMAL SECTOR, POLICY REFORM
AND STRUCTURAL TRANSFORMATION

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ABSTRACT

The Informal Sector, Policy Reform and Structural Transformation

Recent years have witnessed what Judith Tendler aptly calls "a remarkable convergence of fashion on the small enterprise and the informal sector." The paper examines the roles of small and medium enterprises and the informal sector in the context of economic growth and structural transformation, with special reference to Latin America. It finds that the "remarkable convergence of views" is to some extent based on misinterpretation and that some of the policy inferences that have been drawn are wrong.

The record of employment and productivity growth in Latin America is reviewed. Compared to other countries at their respective income levels, Latin American countries have less employment in agriculture. There is much low-productivity employment in the industrial and service sectors, despite relatively rapid employment growth in industry. Structural transformation in the region has been suspended as a result of policy choices such as chronically overvalued exchange rates, high levels of effective protection, high tax rates combined with measures of tax relief which encourage the use of capital, labor protection laws, interventionist financial policies and pervasive government regulation of economic activity. Prospects for reforming these policies to permit accelerated growth and transformation are reviewed.

The real cure for urban dualism, which has labor market and enterprise aspects, is development. Dualism gradually disappears as economies grow and generate sufficient demand for unskilled labor. Most of the workers employed at low productivity levels in small or informal enterprises in low income countries eventually find work in larger enterprises. Although many small enterprises survive in rich countries, most of them aim only at providing a livelihood for their proprietor and his/her family; many fail even to do this, going out of business after a few years at most. A few, however, thrive and grow, providing not only productive employment but a vital element of flexibility, innovation and competition to the economy. Policy should encourage both structural transformation and the participation of progressive small and medium firms in this vital process.

THE INFORMAL SECTOR, POLICY REFORM
AND STRUCTURAL TRANSFORMATION

by

Tyler Biggs, Merilee S. Grindle and Donald R. Snodgrass¹

I. INTRODUCTION

A. The Current Enthusiasm for Informal Sector Programs

A lot of people have discovered the informal sector in recent years. In thinking and writing on economic development there has been what Judith Tendler aptly describes as "a remarkable convergence of fashion on the small enterprise and the informal sector" (Tendler, 1988). Neoclassical economists have decided that this part of the economy uses combinations of labor and capital that are "right" for the national factor endowments, unlike the large and formal-sector firms, which are induced by government policies to use excessively capital-intensive and "modern" techniques. Agricultural economists, seeking to reemphasize the importance of agricultural growth, stress that linkages between agriculture and the smaller nonagricultural enter-

prises can be strong and mutually reinforcing. Meanwhile, specialists on both small-scale enterprise and the informal sector have emerged, arguing that these sectors provide livelihoods to large numbers of people, many of them poor, at levels of pay and productivity not necessarily inferior to those generated by large-scale formal-sector firms.

While a wide range of opinion therefore agrees that small-scale enterprises and the informal sector are important for one reason or another, Tendler correctly notes that this convergence of thought has not yet led to a similar consensus on the question of policy -- how best to realize the potentials represented by small-scale enterprises and the informal sector. At least five overlapping but reasonably well defined schools of thought can be identified (Tendler, 1988).

(1) One school defends the programs of direct assistance targeted on small and informal firms that have long been undertaken by many developing country governments and international assistance agencies. It argues that these firms need preferential access to credit, training and other forms of assistance if they are to survive and grow. They merit this assistance, the argument runs, because they support so many people, provide goods consumed by the poor, offer a channel for entrepreneurial development and encourage geographical dispersion of economic activity.

(2) Neoclassical economists criticize this line of reasoning, contending that direct intervention by third world governments through policies and programs targeted on small or informal firms leads to inefficiency and distortions (Little, Mazumdar and Page, 1987). What governments should do is remove policy biases against small and informal-sector firms, in the popular phrase "level the playing field" on which they compete with larger, formally organized firms. Targeted programs and policies are not justified, the neoclassical economists argue, by any clear-cut superiority with respect to productivity or equity. The scale of enterprises operating in any particular sector should be left to the workings of the market, once policy liberalization has permitted the market to work.

(3) A third group maintains that while direct intervention is merited, at least as a form of direct assistance to the poor, governments are neither able to provide effective assistance to the informal sector nor, in many cases, willing to do so. This group notes that the informal sector works largely outside existing laws and regulations, using techniques that government officials may not recognize, condone or even, perhaps, understand. The required assistance should therefore be provided by nongovernment organizations operating in an irregular, nonbureaucratic style.

(4) The argument that the government would not even want to assist the informal sector is based on a view of the informal sector as complementary to the formal sector and very much in the interest of the local elites, who control the formal sector and are influential in the government. In this view, the informal sector provides a pool of low-wage urban employment that can be drawn on as needed to supply labor to formal-sector firms. The government would therefore not want to develop or eliminate the informal sector.

(5) A potential fifth group, for which we are recruiting, accepts the neoclassical economists' criticism of targeted programs and policies but tries to improve on their policy recommendation. As Tendler observes, the rapid growth of the economies of East Asia is currently being reinterpreted as having involved much more government intervention and less reliance on markets to allocate resources than had been thought previously. South Korea and Taiwan were able to promote the development of small and medium enterprises in ways that forced them to perform and limited the growth of rent-seeking behavior. We are currently engaged in reexamining the experiences of some of these countries and comparing them with countries which are at an earlier stage of development to see what principles of constructive intervention to promote the rapid growth of an efficient, labor-absorbing industrial sector can be formulated.

Tendler's "remarkable convergence of opinion" is not limited to the scholars. Increased attention to small-scale enterprise and the informal sector is also evident in the worlds of politics and action. Aid donors, political activists and developing country governments have all joined in. In the United States a remarkable political coalition, stretching from end to end on the right-left spectrum, is backing the proposition that informal sector activities in the developing countries should be promoted more vigorously through small business loan projects funded by the United States Agency for International Development (AID). Conservatives see in this proposal opportunities for expanding entrepreneurship, creating jobs among the poor to help ensure political stability and strengthening the private sector, which they believe to be the true motor of economic development. Liberals support the same measures, seeing in them a grassroots, participatory way to help the poor, a means of generating self-sustained development among poor people to help them escape from poverty.

Governments in many developing countries have also become increasingly interested in the informal sector because of the large number of people whom it supports. At a time when many countries are experiencing severe economic dislocations, governments are concerned about the political consequences of economic

crisis and are looking to promotion of the informal sector as one way to increase employment opportunities for poor people (see, for example, Sanyal, n.d.: 2-3).

In this paper we argue that the "remarkable convergence of views" on small-scale enterprise and the informal sector is to some extent based on misinterpretation and also that some of the policy inferences that have been drawn are wrong. We first lay out our objections, then present an alternative viewpoint.

B. The Definitional Problem

Reexamination of the prevailing consensus starts with the definition of the informal sector itself. Close examination reveals the term "informal sector" as a heuristic device at best. According to the International Labor Office's 1972 report on Kenya, which is widely credited with popularizing the term, "informal activities are the way of doing things, characterized by--

- (a) ease of entry;
- (b) reliance on indigenous resources;
- (c) family ownership of enterprises;
- (d) small scale of operation;
- (e) labor-intensive and adapted technology;
- (f) skills acquired outside the formal school

system; and

(g) unregulated and competitive markets."

These "activities are largely ignored, rarely supported, often regulated and sometimes actively discouraged by the Government."

Logically enough, "the characteristics formal-sector activities are the obverse of these, namely--

- (a) difficult entry;
- (b) frequent reliance on overseas resources;
- (c) corporate ownership;
- (d) large scale of operation;
- (e) capital-intensive and often imported technology;
- (f) formally acquired skills, often expatriate; and
- (g) protected markets (through tariffs, quotas and trade licences)" (ILO, 1972: 6).

Problems arise because the characteristics which are bundled together in these definitions may be found together but may also occur separately. For example, those who emphasize the status of the enterprise in relation to law and regulation insist that size is no criterion; by their definition, informal sector firms may be quite large (de Soto, 1987). But others put the emphasis on enterprise size, usually measured by the number of workers in-

volved. Ray Bromley brings out the ambiguities by listing no fewer than nine "particular deficiencies that are worth mentioning" in "the informal/formal classification, as commonly depicted in the literature" (Bromley, 1979: 1034-1035). A recent review of the literature comments that, notwithstanding hundreds of academic pages devoted to the task, popularizers of the informal sector concept have been "unable to come up with a definition precise enough to be useful for analytical or operational purposes" (Richardson, 1984).

Presented with an enormous quantity of research with differing results depending on the definitional approach adopted, both policy-makers and development practitioners find it hard to respond appropriately to calls to stimulate the growth of the informal sector. It is next to impossible to target that which cannot be defined. Is it workers or is it firms that policymakers should worry about? Is it the broad aspects of poverty which should be directly targeted? Or is it the institutional setting that deserves most attention -- namely government regulatory agencies and the legal system?

Much of the interest in "informal" economic activity in developing countries stems less from the importance of informality itself than from the fact that activities classified as informal tend, on the whole, to exhibit low productivity (Peattie, 1980).²

The problem, as we see it, arises because during the course of economic growth and transformation in many LDCs certain segments of the work force and enterprise population seem to get stuck in low productivity economic activities in industry and services. This suggests that questions related to the informal sector (however defined) cannot be studied in isolation from the rest of the economy but must be addressed in the context of the structural transformation problem. A wholistic, evolutionary analytical framework is required. We need to ask what determines the nature and speed of structural transformation and how these outcomes are affected by market and policy-induced failures.

We propose to refocus attention away from the informal sector as such and directly on the causes and consequences of low-productivity employment. Empirical data indicate that the pattern of "distorted" and/or "unsuccessful" structural transformation can be traced out both in the labor market and in the size distribution and productivity of industrial enterprises. In this paper we analyze these two aspects of the low productivity employment problem, with special emphasis on Latin America.

C. An Alternative Viewpoint

To assist the reader, we close this introductory section by summarizing our main points. For countries at low and middle levels of per capita income, substantial improvement in living standards requires economic growth, the essence of which is rising average income levels. All the important indicators of social welfare are positively correlated with per capita income; in most cases the degree of correlation is high. The distinguished research of Kuznets (1965; 1966) and Chenery (1979; Chenery and Syrquin, 1975) demonstrates conclusively that, except in countries which possess fabulous mineral wealth, economic growth requires structural transformation. This involves a rise in the importance of the industrial sector, both in absolute terms and as a share of aggregate value added and employment. As structural transformation occurs, the importance of the agricultural sector declines. The service sector may either rise or fall as a share of total production and employment.

Besides altering the relative importance of the three main economic sectors, structural transformation also involves important changes within each of these sectors. Within the industrial sector, one of the changes that takes place is a shift from a bimodal distribution of employment in terms of enterprise size --

one in which there is a mountain of workers employed in small enterprises, a low valley in medium-scale enterprises and a smaller peak in large enterprises -- to a unimodal distribution (a single peak and a larger average firm size). In countries at low levels of per capita income, small or "informal sector" firms account for as much as three-quarters of industrial sector employment, but a much smaller share of value added.

Structural transformation within the industrial sector has two components: a "labor reallocation" component (people who are working on their own or in small enterprises eventually find higher-paid jobs in larger firms) and an "enterprise growth" component (a very small number of small enterprises grow into the middle and larger size categories). Quantitatively, the "labor reallocation" component is by far the more important. As emphasized in the "dualistic" models of Lewis (1954) and Fei and Ranis (1964), development occurs largely through the shift of labor to more productive forms of employment. As not stressed by these theories, these shifts take place not just between agriculture and industry but also within all three sectors. Although smaller than the "labor reallocation" component, the "enterprise growth" component is also significant. A dynamic economy permits successful small firms to grow into the middle size category and middle size firms to become large. While most small firms fail

after a few years or remain stagnant, merely earning a living for their proprietors, a few grow and add an important element of dynamism to the economy (Storey et al., 1987).

Although Chenery and others have identified "normal" or average patterns that tend to apply to countries at particular levels of per capita income, there are also substantial variations among countries at similar income levels. Some of these intercountry variations are caused by differences in "givens" such as natural resource endowments, while others result from differences in economic policy.

Many LDCs exhibit the extreme dualism in the distribution of industrial sector employment in terms of enterprise size that we call "the missing middle." We attribute this to policies that favor the largest firms, on the one hand, and in some cases also the smallest ones, on the other. This type of industrial policy can be harmful because it creates a "small firm growth trap" and inhibits the "enterprise growth" component of structural transformation. To shift labor to higher productivity activities, it is necessary to promote growth and labor demand. This in turn requires promotion of the most productive growth agents in the economy.

Even if the GNP of Bangladesh, Burkina Faso or Bolivia could be distributed in equal proportions to the citizens of those

countries, they would still be very poor. The only way to overcome their poverty is through economic growth, and this requires structural transformation which moves labor from less productive activities to more productive ones and permits the progressive minority of small firms to grow.

Several principles of economic policy flow from this argument. First, to the extent that scarce resources have alternative uses for the promotion of economic growth and structural transformation, their use in programs aimed at direct amelioration of poverty is likely to yield smaller gains and thus should be held down. Where potential clients are small and numerous, the administrative costs of direct aid programs may be prohibitive.

Second, enterprise size is not a useful guide to policy determination -- if for no other reason because optimal firm size differs among industries, by market size, between open and closed economies and by levels of development. In most countries, policy discriminates in many ways in favor of large, "formal" firms controlled by the national elite. One of the unfortunate effects of this pattern of discrimination, which usually occurs within the context of an effort to substitute local production for imports, is the reduction of growth opportunities for small and medium size firms. In many cases, small or "informal" firms are

actively suppressed, on the grounds that they are not modern. This is clearly undesirable; the only acceptable basis for such suppression is the limited number of cases (drugs, prostitution, etc.) in which "informal" economic activity poses a direct threat to public order.

Third, however, policy must go beyond mere neutrality -- "the level playing field" -- to active promotion of potentially dynamic firms. Despite the frequent advocacy of policy neutrality by the World Bank and others, no country yet has developed on this basis. To fill in "the missing middle" countries must be able (a) to formulate policies that are performance-based and permit progressive dynamic small and medium sized firms, in effect, to identify themselves and (b) to provide the forms of assistance that will help these firms grow. How to accomplish these two tasks is not yet altogether clear, but the general principle is that what is needed is not policy neutrality but policies which favor firms that turn in favorable performances.

II. THE INFORMAL SECTOR AND STRUCTURAL TRANSFORMATION

A. Employment Aspects of the Problem

1. "Soft" vs "Hard" Employment

At the heart of the problem of low-productivity employment is the notion of "soft" (or labor-supply-pushed) employment versus "hard" (or rest-of-economy-pulled) employment. "Soft" employment (sometimes called underemployment) results when growth in the supply of labor exceeds growth in the demand for labor demand over the long run. This pushes labor into sectors where it is "sponged up" in low-productivity employment. For example, in the service sector, more shoeshine boys and street vendors appear, driving down returns to these activities. In manufacturing, surplus labor may be indicated by "traditional" lower-productivity technologies surviving longer than they should, as small producers are forced to eke out a living at the margin. "Hard" employment, on the other hand, is demand- and productivity-driven. Jobs are created as economic growth proceeds. The demand for labor in this case outstrips supply in various sectors, pulling labor into higher productivity activities with higher relative factor rewards.

There are proximate causes (on the demand side) for "soft" supply-pushed employment, each requiring a different target for policy interventions to correct it. First, "soft" employment can be caused by insufficient aggregate demand -- the "Keynesian employment problem." This is generally only a short-run explanation, although very important in recent years with the debt crisis. Second, employment can be severely affected by price distortions. In factor markets, wages are often out of line with "full-employment equilibrium" rates, causing insufficient demand for labor. In financial markets, controlled interest rates make capital costs artificially low in relatively capital-scarce countries, leading to overly capital intensive production technologies. Product market price distortions may be responsible for even greater labor dislocations. The terms of trade between industry and agriculture are particularly important. Third, non-price distortions are a significant cause of labor demand problems. Malfunctioning institutions, such as poorly operating credit intermediaries red tape-plagued government agencies, and distributional distortions, such as unequal land distribution, can reduce the demand for labor.

Coupled with increasing growth rates of labor force, each of these demand-side factors has played a role in models explaining the problem of low productivity employment in urban areas of

Latin America. Two models have been particularly important in the region -- the ECLA model and the Harris-Todaro model. ECLA represents the "structuralist" view, which emphasizes nonprice distortions. The Harris-Todaro Model represents the neoclassical view, emphasizing price distortions.

ECLA argues that land is artificially scarce in Latin America because it is unequally distributed. High growth rates of rural population combine with this artificial land scarcity to push labor into the cities. In the urban areas, labor supply grows faster than demand because industrial technologies, largely imported from advanced countries, have high and fixed capital coefficients. "Soft" employment increases, particularly in the service sector. The policy recommendations that follow from this view of the low-productivity employment problem involve removing the nonprice distortions by initiating land reform and reducing technological dependence on more advanced countries.

In the Harris-Todaro model, inappropriate urban wage policies (minimum wage laws, government wage rates and the wage policies of multinational corporations) create a large differential between urban and rural wage rates. This encourages rural-urban labor migration, which is limited only by the probability of actually getting an urban job. A sort of lottery of well-paid urban jobs develops, urban labor supply increases faster than labor

demand and "soft" employment results in the service and manufacturing sectors when many of the migrants fail to obtain the high-paid jobs they seek. The policy recommendation in this case is to reduce the factor price distortion, for example by modifying minimum wage laws and government hiring practices.

Whatever causes "soft" employment to increase in a particular case, the situation can be made worse by an inappropriate government response (Gelb, Knight and Sabot, 1987). In many countries, government has tried to offset rapidly growing urban labor supply by expanding employment in the government and public corporations. Often deficit financing has been used to meet the higher payroll that results, with untoward effects on inflation, balance of payments and, in the longer run, the rate of economic growth. Since public sector activities are frequently less productive than private sector activities, a "public sector sink" can emerge, into which increasing amounts of government resources are poured. As these unproductive resource allocations grow and deficit financing taxes the private sector through rising inflation, economic growth suffers, reducing the aggregate demand for labor and increasing the "need" to create unproductive employment in the public sector.

An important lesson to be learned from these models is that "soft" employment can stem from distortions in any sector of the

economy. In the end, the maldistribution of labor caused by these distortions is traced out in an unbalanced process of structural transformation. The problem of "soft" employment thus requires a more complex solution than that personified by a simple programmatic "fix" aimed directly at street vendors. Structural problems, be they maldistribution of agricultural land or distortions in factor and product prices, must be removed or at least reduced. A later section of this paper will discuss the problems involved in trying to bring about such policy reforms.

2. Employment Growth and Urban Surplus Labor in Latin America

What do the data tell us about recent trends in urban employment in Latin America? Do they indicate a growing amount of "soft" employment in all or part of the region? Has modern industrial labor absorption generally been too low to soak up a burgeoning urban work force? And has over-urbanization contributed to the marginalization of large segments of the economically active population?

Advocates of the informal sector concept argue that rapid urbanization and low industrial labor absorption have pushed labor into low-productivity jobs rather than open unemployment

(Mazumdar, 1975; Souza and Tokman, 1976; Sethuraman, 1977). In Latin American, "formal" segments of the industrial sector are often accused of not absorbing enough labor. An examination of structural changes in Latin American employment is instructive in assessing this assertion.

3. Static Comparison of Structural Change in Output and Employment

Almost all the Latin American countries deviate in one striking way from the "standard pattern" of economic structure at different levels of development that emerges from the work of Chenery and associates: the share of agriculture in total employment is lower than is typical of countries at their respective income levels (Table 1 B).³ They also derive less value added from primary production (Table 1 C). These deviations are large in the Southern Cone countries, Colombia, Peru and Bolivia, especially where employment is concerned. Mexico, surprisingly, has more people in agriculture than expected, perhaps as a result of extensive land reforms over the years.

Related to this low agricultural share are rapid urban labor force growth and a high level of urbanization. While the total

TABLE 1

ECONOMIC STRUCTURE IN LATIN AMERICAN COUNTRIES
 COMPARED TO THE INTERNATIONAL "STANDARD" PATTERN FOR 1950-1983
 (Average residuals for the whole period)

A. TRADE AND FINAL DEMAND (% OF GDP)

| | <u>Exports</u> | <u>Primary exports</u> | <u>Manufac- tured exports</u> | <u>Manufac- tured imports</u> | <u>Govern- ment consumption</u> | <u>Gross domestic investment</u> |
|----------------|----------------|------------------------|-----------------------------------|-----------------------------------|-------------------------------------|----------------------------------|
| Venezuela | 2 | 14 | -10 | -3 | -2 | 5 |
| Mexico | -9 | -8 | -5 | -5 | -5 | -3 |
| Argentina | -14 | -7 | -5 | -10 | -3 | -3 |
| Uruguay | -21 | -11 | -8 | -17 | -4 | -11 |
| Brazil | -9 | -6 | -3 | -6 | -2 | 1 |
| Panama | 0 | -- | -- | -- | -2 | -4 |
| Costa Rica | -8 | -4 | -4 | -2 | -3 | -5 |
| Chile | -12 | -2 | -7 | -9 | -3 | -10 |
| Peru | -7 | -3 | -5 | -6 | -3 | -2 |
| Paraguay | -20 | -12 | -5 | -13 | -8 | -6 |
| Dominican Rep. | -10 | -6 | -4 | -8 | -4 | -5 |
| Colombia | -8 | -6 | -3 | -6 | -5 | -3 |
| Ecuador | -9 | -1 | -6 | -5 | -3 | -4 |
| Guatemala | -12 | -6 | -2 | -6 | -7 | -8 |
| Bolivia | -11 | -2 | -4 | -5 | -5 | -6 |
| Nicaragua | -7 | 0 | -5 | -3 | -5 | -7 |
| El Salvador | -4 | -1 | 1 | -2 | -4 | -7 |
| Honduras | -3 | 4 | -3 | 1 | -4 | -4 |
| Mean | -9 | -3 | -5 | -6 | -4 | -5 |

B. EMPLOYMENT AND URBANIZATION

| | <u>% of employment</u> | | | <u>% of population</u> |
|----------------|------------------------|-----------------------------|-----------------|------------------------|
| | <u>Agriculture</u> | <u>Industry^b</u> | <u>Services</u> | <u>Urban share</u> |
| Venezuela | -3 | -6 | 9 | 18 |
| Mexico | 5 | -3 | -2 | 7 |
| Argentina | -27 | 7 | 20 | 30 |
| Uruguay | -19 | 3 | 16 | 29 |
| Brazil | -4 | -4 | 8 | 9 |
| Panama | -7 | -3 | 10 | 7 |
| Costa Rica | -5 | -1 | 6 | -2 |
| Chile | -17 | -6 | 23 | 25 |
| Peru | -6 | 0 | 6 | 15 |
| Paraguay | -6 | 3 | 3 | 1 |
| Dominican Rep. | 1 | -2 | 1 | 4 |
| Colombia | -15 | 2 | 13 | 15 |
| Ecuador | -5 | 3 | 2 | 1 |
| Guatemala | 2 | 0 | -2 | 0 |
| Bolivia | -7 | 6 | 1 | 10 |
| Nicaragua | -2 | -1 | 3 | 15 |
| El Salvador | -5 | 4 | 1 | 8 |
| Honduras | 1 | 0 | -1 | 2 |
| Mean | -7 | 0 | 7 | 11 |

C. VALUE ADDED (% OF GDP)

| | <u>Agriculture</u> | <u>Services</u> | <u>Manufact.</u> | <u>Manufact. disaggregated^a</u> | | |
|----------------|--------------------|-----------------|------------------|--|---------------|-------------|
| | | | | <u>Early</u> | <u>Middle</u> | <u>Late</u> |
| Venezuela | -6 | -3 | -6 | -3 | 1 | -5 |
| Mexico | -5 | 12 | 0 | 2 | 0 | -2 |
| Argentina | -5 | -1 | 9 | -- | -- | -- |
| Uruguay | -1 | 6 | 6 | 6 | 3 | -3 |
| Brazil | -5 | 9 | 5 | 1 | 2 | 3 |
| Panama | -8 | 19 | -1 | 1 | 0 | -1 |
| Costa Rica | 3 | 8 | 4 | 4 | 2 | -2 |
| Chile | -9 | 7 | 5 | 1 | -1 | 3 |
| Feru | -10 | 8 | 8 | 3 | 1 | 1 |
| Paraguay | 7 | 2 | 5 | 4 | 2 | -1 |
| Dominican Rep. | -5 | 8 | 5 | 7 | -1 | -2 |
| Colombia | 2 | 0 | 1 | 2 | 0 | -2 |
| Ecuador | -5 | 7 | 4 | 3 | 1 | -1 |
| Guatemala | -- | -- | -- | 2 | 0 | -1 |
| Bolivia | -10 | 7 | 3 | 3 | -1 | -1 |
| Nicaragua | -1 | 9 | 5 | 2 | 0 | 0 |
| Honduras | 2 | 0 | 4 | -- | -- | -- |
| Mean | -3 | 6 | 4 | 3 | 1 | -1 |

^aEarly: Food, textiles and clothing, and miscellaneous
 Middle: Wood, rubber, chemicals, and nonmetallic minerals.
 Late: Paper and printing, basic metals, metal products, and machinery

Source: Syrquin, 1987.

population of Latin America grew at 2.6 percent per year between 1950 and 1980, urban labor force grew at 4.1 percent (Table 2). The Southern Cone countries, Peru, the Dominican Republic, Bolivia and Nicaragua all have far more urban employment than the international average: (Table 1 B). Latin America has become one of the most urbanized regions in the world, exceeding the expected degree of urbanization for its income level by 14 percentage points.

Since the percentage of employment in industry in Latin America does not differ much from the standard pattern (except in Venezuela, Argentina and Chile), employment in the service sector is necessarily larger than predicted (Table 1 B). The service sector has had to soak up much of labor moved out of agriculture.

4. Dynamic Comparison of Structural Change in Output and Employment

An investigation of the dynamics of structural change adds to the picture presented by the static comparisons in Table 1. Table 3 contains coefficients relating changes in economic structure to rises in income per capita. The coefficients of the income slopes for employment in agriculture, industry and services measure the strength of structural change with respect to income

TABLE 2
GROWTH OF POPULATION AND EMPLOYMENT
IN LATIN AMERICA, 1925-1980
(Average annual growth rates, %)

| | <u>1925-1950</u> | <u>1950-1970</u> | <u>1970-1980</u> |
|---|------------------|------------------|------------------|
| POPULATION | | | |
| Total | 2.2 | 2.8 | 2.5 |
| Urban | 3.5 | 4.4 | 3.8 |
| ECONOMICALLY ACTIVE POPULATION | | | |
| Total | 2.0 | 2.3 | 3.0 |
| Primary | 1.4 | 1.0 | 1.1 |
| Non-primary | 2.9 | 3.6 | 4.2 |
| "Formal" (industry) | --- | 3.7 | 4.1 |
| "Informal"* | --- | 1.5 | 2.1 |
| Distribution of Economically Active Population (percentage) | | | |
| | <u>1925</u> | <u>1980</u> | |
| Primary | 62.3 | 35.9 | |
| Manufacturing | 13.7 | 18.3 | |
| Other Sectors | 24.0 | 45.8 | |

Source: Ramos, 1984, based on ECLA, 1965 and PREALC, 1982.

*"Informal" is defined generally as self-employed plus unpaid family workers.

TABLE 3
TIME SERIES ESTIMATES OF INCOME SLOPES

A. VALUE ADDED

| | <u>Current price shares</u> | | | <u>Constant price shares</u> | | |
|-----------------|-----------------------------|------------------|-----------------|------------------------------|------------------|-----------------|
| | <u>Agricult.</u> | <u>Manufact.</u> | <u>Services</u> | <u>Agricult.</u> | <u>Manufact.</u> | <u>Services</u> |
| Venezuela | -.02 | .11 | -.09 | -.03 | .04 | .18 |
| Mexico | -.11 | .02 | .01 | -.08 | .08 | -.07 |
| Argentina | -.16 | .05 | -.01 | -.15 | .05 | .10 |
| Uruguay | -.13 | .01 | .14 | -.04 | 0 | -.05 |
| Brazil | -.05 | .02 | .03 | -.08 | .03 | -.01 |
| Panama | -.11 | .03 | -.04 | -.12 | .04 | -.04 |
| Costa Rica | -.10 | .08 | -.02 | -.11 | .15 | -.12 |
| Chile | -.06 | .08 | -.10 | -.06 | .08 | .07 |
| Peru | -.30 | .08 | .08 | -.18 | .12 | .02 |
| Paraguay | -.11 | .01 | .05 | -.12 | 0 | .01 |
| Dominican Rep. | -.11 | .03 | -.03 | -.16 | .04 | -.04 |
| Colombia | -.20 | .04 | .11 | -.14 | .04 | .04 |
| Ecuador | -.17 | .02 | -.10 | -- | -- | -- |
| Guatemala | -- | -- | -- | -- | -- | -- |
| Bolivia | -.17 | -.05 | .02 | -.08 | .04 | -.05 |
| Nicaragua | .01 | -.02 | -.02 | -.09 | .12 | .01 |
| El Salvador | -.13 | .08 | .05 | -.20 | .12 | .01 |
| Honduras | -.52 | .19 | .06 | -.31 | .13 | .15 |
| Mean slopes | | | | | | |
| Latin America | -.14 | .05 | .01 | -.12 | .06 | .01 |
| Low-Y countries | -.24 | .06 | .09 | -.19 | .07 | .08 |
| Lower middle Y | -.17 | .05 | .03 | -.14 | .04 | .05 |
| Upper middle Y | -.12 | .03 | 0 | -.11 | .06 | .02 |
| Industrial | -.09 | -.05 | .16 | -.05 | .03 | .02 |

B. EMPLOYMENT

| | <u>Agriculture</u> | <u>Industry</u> | <u>Services</u> |
|-------------------------------|--------------------|-----------------|-----------------|
| Venezuela | -.34 | .08 | .26 |
| Mexico | -.26 | .09 | .17 |
| Argentina | -.19 | -.13 | .32 |
| Uruguay | -.30 | .10 | .20 |
| Brazil | -.22 | .09 | .13 |
| Panama | -.21 | .04 | .17 |
| Costa Rica | -.34 | .07 | .27 |
| Chile | -.21 | .01 | .20 |
| Peru | -.21 | 0 | .21 |
| Paraguay | -.11 | .01 | .10 |
| Dominican Republic | -.25 | .08 | .17 |
| Colombia | -.46 | .05 | .41 |
| Ecuador | -.07 | -.02 | .09 |
| Guatemala | -.22 | .10 | .12 |
| Bolivia | -.26 | .13 | .13 |
| Nicaragua | -.30 | 0 | .30 |
| El Salvador | -.29 | .14 | .15 |
| Honduras | -.26 | .27 | .01 |
| Mean slopes | | | |
| Latin America | -.24 | .06 | .16 |
| Low income countries | -.10 | .05 | .05 |
| Lower middle income countries | -.20 | .07 | .13 |
| Upper middle income countries | -.22 | .08 | .14 |
| Industrial countries | -.27 | .01 | .17 |

C. TRADE AND INVESTMENT

| | <u>Exports</u> | | Primary <u>exports</u> | Mfrd. <u>exports</u> | <u>Investment</u> | |
|-----------------|--------------------------|---------------------------|---------------------------|-------------------------|--------------------------|---------------------------|
| | <u>Current price</u> | <u>Constant price</u> | | | <u>Current price</u> | <u>Constant price</u> |
| Venezuela | -.05 | -.28 | 0 | -.01 | 0 | .09 |
| Mexico | -.02 | -.01 | -.01 | .01 | .09 | .09 |
| Argentina | .01 | .01 | -.02 | .05 | .17 | .09 |
| Uruguay | .08 | -- | -.08 | .11 | -.01 | -- |
| Brazil | .01 | .01 | -.01 | .03 | .01 | .04 |
| Panama | -- | -- | -- | -- | .18 | -- |
| Costa Rica | .17 | .24 | .02 | .11 | .15 | .12 |
| Chile | -.13 | -.07 | -.13 | -.02 | .19 | .24 |
| Peru | -.04 | -.10 | -.31 | .05 | -.16 | -.10 |
| Paraguay | -.07 | -.06 | .01 | .01 | .21 | .32 |
| Dominican Rep. | -.03 | -.03 | .02 | .06 | .16 | .19 |
| Colombia | .03 | -.06 | 0 | .05 | .05 | -.03 |
| Ecuador | .10 | .14 | .13 | .01 | .14 | 0 |
| Guatemala | .15 | .14 | .07 | .06 | .14 | .04 |
| Bolivia | .13 | -.04 | .17 | 0 | .21 | .19 |
| Nicaragua | .03 | .14 | 0 | .05 | .15 | .16 |
| El Salvador | -.23 | .22 | .24 | .13 | .21 | .18 |
| Honduras | .39 | .37 | .37 | .12 | .33 | .33 |
| Mean slopes | | | | | | |
| Latin America | .03 | .04 | .01 | .06 | .14 | .12 |
| Low-Y countries | .05 | 0 | -.02 | 0 | .16 | .12 |
| Lower middle-Y | .11 | .09 | .09 | .04 | .14 | .12 |
| Upper middle-Y | .10 | .07 | 0 | .11 | .12 | .13 |
| Industrial | .08 | .20 | .01 | .12 | .02 | 0 |

Source: Syrquin, 1987.

per capita (but not necessarily with respect to time). The data show that structural transformation in employment has been more pronounced than the transformation of production in Latin America since 1950. As per capita income increased, substantial reallocation of labor from agriculture to industry and services took place (Table 3 B). The developed countries took twice as long to accomplish a similar transformation (Tokman, 1992). The difference is not attributable to any greater strength of structural transformation in the case of Latin America; the coefficient for agriculture was $-.24$ in Latin America, compared to $-.27$ in the industrial countries. Rather, the explanation lies in a sharp difference in overall growth rates. Industrial countries grew at an average rate of 1.3 percent per year from 1970 to 1990 (the period used for the comparison), while Latin American countries averaged annual growth of 3 percent from 1950 to 1980 (Maddison, 1980).

One-quarter of the labor which left agriculture in Latin America went into the industrial sector (comprising mining, manufacturing, construction and public utilities), while three-quarters went to services (Table 3 B). The rate of labor absorption in industry was lower than the average for upper- and middle-income countries (Table 3 B), where about one-third of the labor shifted out of agriculture was absorbed into industry.

Among Latin American countries, labor absorption in industry was particularly slow in Argentina, Chile, Peru and Colombia.

The unbalanced absorption of labor to services as structural transformation proceeds is no great surprise. Thirty years ago Kuznets found that "...in most countries the substantial decline in share of agriculture is compensated by a substantial rise in share of services, not by a rise in share of industry" (Kuznets, 1966). What is surprising is the slower decline of agriculture with respect to per capita income (on average) in Latin America (-.24) relative to the historical experience for industrial countries (-.27), particularly given the concern in Latin America about its disproportionately high rate of urbanization. Faster income growth would appear to be the culprit, not structural problems. Also surprising is the slightly lower share of shifting labor force taken up by industry. This, however, may only be a statistical anomaly.

5. The Rate and Structure of Urban Industrial Labor Absorption

Does the large shift of labor force from agriculture to urban tertiary employment in Latin America imply a failure of modern industry to expand employment opportunities? Although we

have seen that Latin American industry took in a slightly smaller percentage of the labor force shifted out of agriculture than the average for middle income countries, evidence indicates that this was not the case in most countries.

In general, annual growth rates of industrial employment in Latin America kept pace with the growth of the economically active nonagricultural population between 1950 and 1980 (see Table 2).⁴ These growth rates, in fact, were analogous to those of more developed regions during their periods of rapid structural change and development (Kuznets, 1966; Tokman, 1982). A number of countries had especially rapid growth of industrial employment: in Brazil modern industrial employment grew at an average annual rate of 4.3 percent, 1950-80; in Mexico the comparable average was 5.0 percent. Pulling down the regional average were countries such as Peru (2.8 percent average annual growth), Chile (2.3 percent), Argentina (1.7 percent) and Uruguay (0.9 percent) (Table 4). The main reason for this significant increase in industrial employment was the growth of industrial product over the period. As Table 1 C shows, Latin American countries generally did better than the standard pattern in terms of growth of manufacturing value added. In most countries growth in industrial output was fast enough to absorb the large inflow of labor supply from the rural sector.

TABLE 4

GROWTH EMPLOYMENT AND OUTPUT IN SELECTED LATIN AMERICAN
COUNTRIES, KOREA, TAIWAN, AND THE PHILIPPINES

| <u>Country</u> | <u>Period</u> | <u>Employment</u> | <u>Value Added</u> |
|----------------|---------------|-------------------|--------------------|
| Argentina | 1950-60 | 2.1 | 4.1 |
| | 1960-70 | -0.1 | 5.6 |
| | 1970-80 | 1.1 | 1.6 |
| Brazil | 1950-60 | 3.3 | 9.1 |
| | 1960-70 | 3.4 | 6.9 |
| | 1970-80 | 6.9 | 9.2 |
| Chile | 1950-60 | 0.7 | 4.7 |
| | 1960-70 | 3.1 | 5.3 |
| | 1970-80 | 2.1 | 1.4 |
| Colombia | 1950-60 | 2.4 | 6.5 |
| | 1960-70 | 5.8 | 6.0 |
| | 1970-80 | 0.3 | 5.6 |

TABLE 4 (continued)

| | | | |
|-------------|---------|------|------|
| Mexico | 1950-60 | 3.9 | 6.2 |
| | 1960-70 | 5.8 | 9.1 |
| | 1970-80 | 7.0 | 7.2 |
| Peru | 1950-60 | 0.3 | 0 |
| | 1960-70 | 0 | 5.8 |
| | 1970-80 | 1.7 | 3.4 |
| Korea | 1960-70 | 16.4 | 32.6 |
| | 1970-80 | 9.0 | 34.4 |
| | 1980-85 | 3.3 | 2.9 |
| Taiwan | 1956-60 | 4.4 | 20.7 |
| | 1960-70 | 6.4 | 20.3 |
| | 1970-80 | 8.4 | 22.8 |
| | 1980-85 | 3.1 | 10.0 |
| Philippines | 1956-60 | 1.0 | 13.8 |
| | 1960-70 | 2.5 | 12.3 |
| | 1970-80 | 3.4 | 21.5 |
| | 1980-85 | 0.8 | 18.6 |

Source: For Latin America: ECLA, 1985.

For Korea, Taiwan, and Philippines: EEPA estimates.

Data on the rise of sectoral productivity over the 1950-1980 period generally confirm that the growth of urban employment was driven by demand rather than supply. "Excessive" growth of the service sector (an increase in "soft" employment) would have led to falling productivity in the sector. In fact, productivity rose at an average of nearly 2 percent a year over the three decades (Table 5). There is also evidence that the fastest growing jobs in the service sector during this period were for qualified non-manual employees -- professionals, technical and clerical (Ramos, 1984: 74). There is no indication that average real wages in tertiary employment declined in the observed period. Nor did average wages in other urban activities, such as construction and activities designated as "informal" decline over the period (Ramos, 1984: 74; Gregory, 1986; Pfefferman and Webb, 1979). No large increase in marginal employment can be detected. It is true, of course, that annual rates of industrial growth and employment in most countries of Latin America could have been even higher. Over a comparable period East Asian countries recorded average annual rates of industrial employment growth as high as 16 percent (Table 4). The main reason that Latin America's performance was weaker than it might have been was its trade orientation. Trade levels in the region fall well below pre-

TABLE 5

SECTORAL PRODUCTIVITY GROWTH RATES,
LATIN AMERICA, 1950-1980

| | <u>1950-60</u> | <u>1960-70</u> | <u>1970-80</u> | <u>1950-80</u> |
|----------|----------------|----------------|----------------|----------------|
| Primary | 3.3 | 2.3 | 2.4 | 2.6 |
| Industry | 2.8 | 2.8 | 2.3 | 2.7 |
| Tertiary | 1.0 | 2.2 | 2.1 | 1.8 |
| Total | 2.9 | 3.1 | 2.9 | 3.0 |

Source: PREALC, 1982, Quoted in Ramos, 1984, p. 74.

dicted values for countries at similar levels of development (Tables 1A and 3C). Latin American countries took only a limited part in the explosion of world trade in the post-war period. Most countries in the region followed a classic import substitution strategy. Some economists argue that the protectionist policies used to implement this strategy, particularly for heavy industry, have been "only a preamble to a future export stage, providing the learning required before reaching out for markets abroad" (Teitel and Thoumi, 1986, p. 486). But even if this proves to be correct in the long run evidence shows that the short-run employment trade-off has been substantial in some cases. Inward-oriented strategies, favoring the production of import-competing goods at the expense of exportables, use much less unskilled labor than exports (Kreuger et al., 1983). There also seems to be a significant interaction between import substitution strategies and factor market price distortions, leading to high capital/output ratios and reduced demand for labor. Finally, faster growth under outward-looking strategies can lead to greater employment creation (Kreuger et al., 1983; Chenery, Robinson and Syrquin, 1986).

In other important areas, such as gross domestic investment, Latin America fits the "normal" pattern. For the region as a whole, investment as a share on GNP rose at a pace similar to

that of other developing countries (Tables 1 and 3). Only Peru had abnormally low investment. Further, if we compare a developed country like the United States in an early period of growth -- say 1870 to 1906 -- with Latin America in 1950-80, average investment rates are similar: about 20 percent of GDP.

In sum, Latin America as a region achieved a rapid shift of labor from agriculture to industry and services in the three decades after 1950. This structural transformation was fostered by a population explosion in the 1950s and by rapid growth of national product. Growth in industrial and tertiary value added was large enough to absorb urban population growth averaging 4 percent a year without declines in productivity or real wages of urban workers. This shows that economic growth is the decisive factor in easing employment problems. Experience since 1980 reinforces this observation: during the economic crisis that afflicted the region in 1981-83, when per capita GNP fell for three consecutive years for the first time since the 1930s, unemployment took a sharp upswing (Ramos, 1984: 79).

6. The Problem of Structural Heterogeneity

That Latin America as a region absorbed much greater amounts of labor in industry than is acknowledged by many observers, par-

ticularly the informal sector enthusiasts, does not mean that it had no employment problems. Despite the positive trend, there were problems in some periods and in some countries. Peru, Argentina and Chile saw significant increases in "soft" employment in the service sector during the 1970s and early 1980s. In Chile and Argentina the problem was caused by neoconservative stabilization and liberalization policies; in Peru, by a severe recession in 1975-78. Several countries experienced large regional imbalances and a kind of metropolization of the labor force. But the most disconcerting aspect of employment growth in Latin America has been the persistence of structural heterogeneity -- the fact that much of the urban economically active population continues to work in low-productivity activities, often side-by-side with high-productivity activities in the same sector. This has meant that conditions of employment have stagnated for a large segment of the urban work force.⁵ The central cause of structural heterogeneity, particularly its persistence over time, is inappropriate public policy.

By the early 1980s estimates put urban low-productivity employment in Latin America at 30 to 40 percent of the total, depending on how low productivity is defined. This figure is similar to estimates of the proportion of "informal" workers in the United States and other developed countries for comparable

historical periods (1900-1930) (Tokman, 1982). But there is a difference between the employment structures of low productivity activities in the two cases (Table 6). In the United States in the early 1900s, "informal" employment was concentrated in service activities. In Latin America it is equally distributed between manufacturing and services. Dualism in Latin American manufacturing is pronounced and seems to be stable over time. In the United States, self-employment in manufacturing was relatively small by 1900 and declined substantially over the next three decades.

Why have the self-employed in manufacturing not been incorporated into more modern segments of industry as growth accelerated in most Latin American countries? As structural transformation of the economy proceeds and industrialization picks up speed, the first type of urban employment that should shrink is self-employment in manufacturing. There are two reasons for this. First, modern technology (usually imported), which is the engine of industrial development, should increasingly displace the majority of traditional, artisanal and other low-productivity methods. Second, the absorption of labor into more modern production should affect first those workers with training and occupational skills. Self-employed artisans are generally among the most skilled workers available. The fact that the share of

TABLE 6

COMPARISON OF THE STRUCTURE OF URBAN EMPLOYMENT IN
LATIN AMERICA (1950-1980) AND THE UNITED STATES (1900-1930)

| | <u>"Informal"</u> <u>workers</u> ^a | <u>Self-employed</u> ^b | <u>Self-employed in</u> <u>manufacturing</u> ^c |
|------|--|-----------------------------------|--|
| | <u>Latin America</u> | | |
| 1950 | 46.5 | 27.3 | 22.1 |
| 1960 | 44.8 | 28.1 | 21.5 |
| 1970 | 44.0 | 28.3 | 20.7 |
| 1980 | 42.2 | -- | -- |
| | <u>United States</u> | | |
| 1900 | 50.8 | 34.0 | 7.2 |
| 1910 | 41.8 | 29.3 | 6.0 |
| 1920 | 34.5 | 26.1 | 4.4 |
| 1930 | 31.2 | 23.1 | 3.0 |

a. Percentage of the total labor force. Informal workers are defined as the sum of the self-employed, unremunerated family workers, and domestic servants.

b. Percentage of the total labor force.

c. Percentage of the manufacturing labor force.

Source: Portes and Benson, 1984, taken from PREALC, 1982; Tokman, 1982: Table 4; Lebergott, 1964: Tables A3 and A7.

self-employed persons in manufacturing remained constant over 30 years means that the absolute number of such people increased by at least 1.8 million workers (Portes and Benson, 1984). In the face of reasonably rapid rates of industrial growth, a decline in this segment of the work force would have been predicted. What has occurred, therefore, is a suspension of the process of efficient structural transformation in production.

Suspended structural transformation is the result of policy choices which have important historical, institutional and political antecedents. A short list of some of economic policies that have shaped structural transformation in Latin American countries would have to include the following:

- chronically overvalued exchange rates;
- high levels of effective protection;
- high taxes, combined with measures of tax relief which encourage the use of capital;
- labor protection laws;
- unions;
- financial market policies which include controlled interest rates and selective credit controls; and
- pervasive government regulations on all kinds of economic activity.

These policies have impeded growth and structural transformation of the economy along a path that would continually shift workers

to economic activities with higher levels of productivity and have distorted incentives in such a way that low-productivity employment becomes an efficient mode of production -- in some cases, perhaps the only possible mode of operation.

The policy environment has been responsible for at least two important distortions in labor markets that have influenced the structure of economic activity.

First, wage rigidities have been created by labor laws, government regulations and union activities. In many countries, laws which provide expensive forms of insurance for contractually hired workers and protect them from dismissals during downturns in economic activity have resulted in the emergence of two modes of labor utilization in both manufacturing and services -- contractual and casual (Portes and Benson, 1984). These measures have made employers reluctant to increase the number of contractually hired workers, since this raises costs and decreases managerial flexibility. Instead, they rely more on the highly elastic labor supply offered by the pool of casual and self-employed workers in manufacturing. This labor supply is accessible through two channels: direct hiring on a casual basis (eventuales) and sub-contracting of production or marketing services to small establishments or households. These types of labor utilization make it possible for "modern" manufacturing (and service)

establishments to pay "traditional" wages. The popularity of these devices leads to a distortion in the employment statistics, since many of those who are de facto employed by modern industry are recorded as engaged in "informal" activities.

This mode of labor utilization is fundamentally different from the one required for efficient structural transformation. In a less distorted policy environment, employers, responding to the prevailing competitive pressures and opportunities, would reach out to workers and sub-contractors in more positive ways. The emphasis would be on finding ways to reduce costs and increase productivity, not on how to get around policy-induced cost increases and distortions. Workers would be trained to upgrade their skills and reduce turnover, and high-quality sub-contractors would be actively recruited and provided with equipment, loans and training in quality control. These practices reflect continuous pressure to improve the conditions of employment as growth proceeds.

Second, policy-imposed distortions have impeded technological adoption and learning by increasing the cost of modernizing and expanding firms (Nelson, Schultz and Sleighton, 1971). Competitive labor markets put pressure on lagging firms to upgrade their production techniques and eliminate low-productivity economic activities. Slower adoption of new technology increases

the survival space for lagging, more traditional firms (Winter, 1964). When incentives are severely distorted by policies and regulations, the process of growth and structural transformation can become stalled.

Society loses when the shift of labor to more productive uses and more efficient units of production is slowed down. One study on Colombia measured the economic returns to shifting labor from lower to higher productivity units of production within an industry as 20 to 30 percent of the reported increases in value added per worker for the period 1958-1965 (Nelson, Schultz and Sleighton, 1971). If the benefits to be gained from shifting labor to higher productivity sectors by removing policy-induced distortions in factor markets were added in, the potential gains would be even more impressive.

As we have already noted, significant intersectoral employment shifts occurred in Latin America between 1950 and 1980. Such labor reallocation contributes to the growth of productivity when it improves the allocation of resources (Chenery, Robinson and Syrquin, 1986). A crude measure of labor productivity by sector is output per worker in the sector, relative to the average for the whole economy (Table 7). Differences in the average product of labor reflect the faster growth of total factor productivity in "modern" activities, as well as policy-induced

misallocation of labor, such as the large and relatively stable self-employment in manufacturing and surplus labor in agriculture and services.

Reallocation of labor from low-productivity sectors to higher-productivity sectors allows average productivity in the economy as a whole to grow faster than the average of the sectoral rates. Between 1960 and 1980, such labor shifts accounted for about 28 percent of average growth in output per worker in Latin America, a figure similar to the average for upper middle-income countries (Table 7). When resources are not allocated efficiently, the resulting slack in the economy becomes a potential source of growth. Rapid shifts may contribute to the acceleration of growth, but such shifts are made possible by high rates of output growth and investment. As measured by the extent of self-employment in 1980 (Table 6), considerable slack existed in the economies of Latin America, especially in Peru, Colombia and the Southern Cone countries. The economic crisis since 1980 has undoubtedly increased this slack.

7. Implications for Policy Goals and Programs to Deal with the Informal Sector

First, there is no getting around the fact that economic growth is a decisive factor in eliminating supply-pushed, low-

TABLE 7

RELATIVE PRODUCTIVITY BY SECTOR

(Total GDP per worker = 100)

Effect of reallocation
on productivity growth

| | <u>1960</u> | | | <u>1980</u> | | | Annual rate | Percent of growth of productivity |
|----------------|-------------|------|-------|-------------|------|-------|----------------|---|
| | Agric. | Ind. | Serv. | Agric. | Ind. | Serv. | | |
| Venezuela | 17 | 168 | 132 | 36 | 164 | 86 | 0.9 | 42 |
| Uruguay | 93 | 89 | 109 | 69 | 108 | 105 | 0.1 | 6 |
| Chile | 30 | 163 | 117 | 42 | 141 | 99 | 0.6 | 60 |
| Argentina | 100 | 80 | 116 | 68 | 105 | 105 | 0.1 | 2 |
| Mexico | 29 | 145 | 220 | 23 | 125 | 163 | 1.2 | 32 |
| Costa Rica | 51 | 101 | 183 | 57 | 108 | 125 | 0.9 | 37 |
| Peru | 34 | 167 | 178 | 21 | 237 | 106 | 0.7 | 53 |
| Panama | 34 | 115 | 190 | 28 | 97 | 147 | 1.1 | 36 |
| Brazil | 36 | 225 | 145 | 45 | 128 | 123 | 1.3 | 22 |
| Colombia | 63 | 127 | 147 | 63 | 110 | 124 | 0.5 | 24 |
| Nicaragua | 38 | 123 | 261 | 48 | 179 | 132 | 1.0 | 100 |
| Paraguay | 65 | 101 | 180 | 60 | 110 | 158 | 0.3 | 10 |
| Dominican Rep. | 40 | 182 | 240 | 45 | 170 | 137 | 1.4 | 42 |
| El Salvador | 51 | 106 | 237 | 49 | 127 | 182 | 0.5 | 29 |
| Bolivia | 42 | 133 | 240 | 38 | 141 | 159 | 1.2 | 47 |
| Honduras | 53 | 172 | 231 | 47 | 150 | 207 | 0.7 | 48 |
| Means | | | | | | | | |
| Latin America | 46 | 129 | 172 | 44 | 137 | 126 | 0.7 | 28 |
| Lower mid-Y | 51 | 227 | 217 | 40 | 206 | 154 | 1.2 | 40 |
| Upper mid-Y | 37 | 165 | 158 | 33 | 139 | 121 | 1.0 | 26 |
| 12 Industrial* | 64 | 113 | 123 | 68 | 115 | 98 | 0.2 | 5 |

*1950 and 1976.

Sources: Maddison, 1980; World Bank, 1983; Syrquin, 1987.

productivity employment. Rapid growth in industrial value added is a lot like riding a bicycle -- the faster it goes the more stable it gets. In fast-growing economies, many problems are self-correcting -- resources are reallocated more smoothly, both within and between sectors, and real wages are pulled up by the general rise in the aggregate demand for labor.

Second, policy and program interventions should foster a more efficient structural transformation by stimulating economic growth and smoothing the way for effective adjustment of resources to accommodate the growth process. They should not perpetuate structural heterogeneity.

Third, the forces that come together to create urban employment problems are conditioned in complex ways by economy-wide development policies and by institutional problems. The way in which agriculture develops, the initial levels and pace of human capital development and the effects of trade policies, to name a few, all play a role. Considering the complex interactions of forces affecting low-productivity employment, it is facile to think that a "policy fix" aimed at solving the problem directly at the microeconomic level is the answer. The problem must be addressed at both the micro- and the macro-economic levels.

Fourth, the size of the self-employment sector is less troubling than its composition and the stability of such employment.

To address these problems, policies and programs must aim at removing distortions that have driven the economy away from efficient growth and transformation.

Fifth, with rapid urbanization and a policy regime that benefits only a limited number of workers, an individual's choice of "informal" employment in industry may be rational and efficient in the short run. In the longer run, however, substantial economic and social gains depend on the achievement of much higher productivity levels through the creation of more efficient units of production. As these units are created, labor will be drawn into more highly organized sectors of the economy, where there is better protection of property and contractual rights and higher wages and benefits.

B. Enterprise Aspects of the Problem

1. Firm Size Distribution and Economic Development

The size distribution of industrial enterprises is systematically related to levels of economic development. Broadly speaking, there are three stages. In the first phase, household and cottage-shop manufacturing predominates, accounting for 50 to 75 percent of total manufacturing employment. In the second, small

and medium workshops and factories emerge at a comparatively rapid rate and replace cottage-shop manufacturing in many sectors. In the third, large-scale production becomes predominant, displacing the remaining cottage-shop activities and much, but not all, of the workshop and small-scale production (Anderson, 1982). None of these phases, however, is distinct. Countries move gradually from one stage to the next and the rate of change is likely to differ among industrial sectors and regions of a developing country.

The forces that drive the organization of manufacturing activity through these phases and thus ultimately determine, in large part, the firm size structure at any given time are extremely complex. Among the most important influences are (1) rises in per capita income and resultant changes in patterns of domestic demand; (2) the development and adoption of new technologies; and (3) the influence of government policy on these two variables.

Increases in per capita income alter the mix of industrial sector outputs demanded. Over time, there is likely to be a shift toward more sophisticated products, which are most efficiently produced by larger firms (i.e., products for which there are economies of scale in production). This causes the structure of manufacturing activity to shift toward larger firms. On the

supply side, changes in technology may also lead to production by larger firms. Adoption by poorer countries of technologies developed in richer countries leads in this direction, since such technologies were usually developed to cope with conditions of expensive labor and cheap capital equipment.

Government policy can have profound implications for both the product mix and the production technologies used within industries. For example, policies which distort trade patterns may result in a "premature" shift of resources into industries that require more complex, capital-intensive production arrangements. The size structure of industry in this case becomes more skewed towards large firms as production shifts to products that require capital-intensive techniques and longer production runs. Financial policies can have a similar impact. Controlled interest rates and credit rationing generally discriminate against small firms, promoting larger firm size in every industry.

In a low-income country the distribution of industrial employment by firm size is likely to be bimodal, with many, possibly most, workers employed in small enterprises, few employed in medium-size enterprises and the remainder employed in large enterprises.

Comparisons of the distribution of industrial sector employment in several Latin American countries with distributions for a

number of other countries show definite skewness toward large enterprises in Latin America, much like the manufacturing sectors of advanced industrial countries (the United States, United Kingdom, West Germany). In the advanced industrial countries cottage and small firms have, over time, been incorporated into the modern manufacturing sector; in Latin America, manufacturing remains highly dualistic, with a pronounced distinction between large, capital-intensive continuous-process manufacturing establishments, on the one hand, and small-scale, job-shop establishments using traditional technology, on the other. Changes in industrial structure have occurred, but the household and cottage sector remains large.

Government policy affects the evolution of firm-size distribution in the industrial sector in two main ways: by impeding the entry of new firms to the upper reaches of the size distribution and by creating a "growth trap" which helps to keep small firms with growth potential near the bottom of the distribution. Significant gains in output and productivity can be made by creating a policy environment which stimulates the participation of small and medium sized firms. For these gains to be realized, policy must permit (and preferably facilitate) both the growth of small firms into the middle size range and the creation of new medium-size firms.

2. Economic Advantages of the Dynamic Middle

While there are important economic advantages for any developing country in having an industrial structure that contains a sizeable group of progressive small and medium enterprises, it does not follow that indiscriminate promotion of small and medium firms should be a policy goal. Rather, by formulating a policy regime which encourages progressive small and medium enterprises to participate in efficient industrial growth a country can create not only a setting conducive to growth and development but also positive externalities that make the economy more resilient, vital and equitable. Policy should not seek to establish more small and medium firms. Instead, it should try to build up a sizeable group of progressive small and medium enterprises ("firms with a strategy") that are competitive and innovative at home and abroad. Such firms can help to spark higher rates of economic growth and foster a more equitable income distribution.

Competitiveness. For a market economy to function properly, it must be competitive. Competition depends on the presence of many sellers and the absence of dominant large ones. These conditions are generally met in international markets because few countries export or import enough of a single commodity to influ-

ence market price. In domestic markets, however, a combination of various forms of trade protection and policies which limit entry or promote excessive size and industrial concentration can severely reduce competition. Several Latin American countries provide examples of what can happen to industry when it is heavily protected from international competition and government policies limit competition in domestic markets.

Taiwan and South Korea furnish instructive contrasts to the Latin American situation. In Taiwan, the conditions of competition and proper functioning of markets are better fulfilled than in most other private enterprise economies. The presence of many small and medium firms in the domestic market and only limited protection from foreign competition foster innovativeness and rapidly rising productivity. Firms that fail to reduce costs to competitive levels do not survive. New technologies and innovations in one industry or sector spread quickly to others. Korea, on the other hand, has more large firms and more state intervention, and thus also has less domestic competition than Taiwan. But Korea fosters competition in its industrial sector by exposing its firms to international competition and through policies that reward only those forms which perform. In this fashion, it has made its industrial sector one of the fastest growing in the world. Together, Taiwan and Korea show that the firm size struc-

ture itself is not decisive for competitiveness and productivity growth. Korea has a firm size distribution that is similar to those of many less dynamic economies, but it follows policies which produce rapid economic growth.

Adjusting to economic shocks. When industrial firms become too large, the resilience of the economy declines. Small and medium firms render the always painful adaption of the economy to changing circumstances a little more bearable. Large firms often resist cutting down their operations, thereby prolonging the agony but not obviating the necessity of change. When domestic and international shocks hit, major changes in the pattern and scale of manufacturing production are called for; small average firm size facilitates the process of adjustment.

Flexibility to adapt to capricious international markets. Industrial growth and participation in international markets requires progressive small and medium firms flexible enough to respond to the changes in prices, tastes and changes in technology that occur so frequently. This is true even in those developed countries which have had success in export markets in recent years, such as West Germany.

Employment and income distribution. It is often argued that, for any given level of investment, small enterprises create more employment than large enterprises. For this to offer

policy-makers opportunities to increase productive employment, small enterprises in important industries must not only be more labor-intensive than large enterprises but must also use resources as efficiently as the large firms. If they are labor-intensive but less efficient, special encouragement of small enterprise entails a trade-off between expansion of output and additional jobs. If, on the other hand, small and medium firms do not turn out to be clearly more labor-intensive, even the employment argument for preferential policies and programs disappears.

In any case, recent surveys of narrowly defined industries in India, Colombia, the Philippines and elsewhere suggest that the notion that small manufacturing enterprises are more efficient users of resources than large enterprises has no general validity, from either a technical or a social point of view (Little, Mazumdar and Page, 1987; Cortes, Berry and Ishaq, 1987). Medium-size enterprises, on the other hand, were found to be the most efficient in many industries. This suggests that a "missing middle" in the enterprise size structure, holding other things constant, may imply reduced industrial efficiency.

On the subject of relative factor intensity, the studies cited above arrive at a somewhat surprising conclusion. In some industries differences in labor intensity between large and small enterprises are small. Very small modern factories or workshops

may be highly capital-intensive. Moreover, the differences in labor intensity among firm size classes within industries that do exist are dwarfed by differences among industries. This implies that, for manufacturing as a whole, small and very small firms are labor-intensive because labor-intensive industries have a relatively high proportion of small enterprises. That is, small enterprises are labor-intensive because they are usually found in labor-intensive industries, not because they are always and everywhere labor-intensive. This conclusion points to the importance of a country's pattern of industrial output for both the existence and factor intensity of small enterprises.

What does all of this ultimately say about small and medium enterprises and employment? In essence, the studies show that indiscriminate promotion of small and medium and enterprise is not the solution to the employment problem in developing countries. There are at least two reasons. First, programs and policies that target small-scale enterprises indiscriminately may achieve short-term employment gains at the expense of longer-run efficiency and even greater potential employment benefits. Second, expanding employment is not the only relevant policy goal. The conditions of employment are equally important. Creating more jobs at low and stagnant or declining real wages may help relieve immediate distress, but it is not development. Employ-

ment growth in low-paid cottage industries or service activities indicates a lack of development, not its presence.

Policies and programs aimed at promoting efficient industrial growth and an industrial structure with a progressive "middle" of small and medium firms would, in our view, substantially allay the output-employment trade-off. First, such firms are likely to be both efficient and relatively labor-intensive. Second, their growth fosters an efficient industrial development process that will yield many high-productivity jobs over the longer run. Trade liberalization, investment incentives and regional policies that encourage the participation of progressive small firms twist the pattern of industrial output in the direction of comparative advantage and induce technology choices more in line with local resource endowments.

A policy environment which supports the entry and expansion of progressive smaller firms would similarly work to enhance the conditions of employment in several ways.

First, the locomotive driving manufacturing growth and structural transformation in developing countries is the process of technological learning. Unlike the earliest industrializing countries of the 18th and 19th centuries, in which invention sparked industrialization, 20th century industrializers acquire technological competence by importing foreign technologies,

adapting them to local conditions and learning by doing as they move through the international product cycle. Within a given country industries, firms and entrepreneurs differ greatly in their ability to acquire necessary technological capability and new technologies. Thus at any particular time there is considerable variation among firms with respect to the vintage of technology used. The ability to acquire technological capability is not just a function of the level of human resource development (education and experience) but is also influenced by the investment climate and the policy regime. Further, imperfections in domestic factor markets, either policy-induced or other, tend to slow down the acquisition of technological capability by raising the cost of firm expansion.

A lag in the acquisition and diffusion of technology means slower industrial growth and either stagnating or deteriorating conditions of employment (constant or falling value added per worker), depending on the rate of labor force growth. It also means that there is less survival pressure on inefficient producers to modernize and thus a slower shift in the composition of the work force toward higher-productivity activities and enterprises and away from household and cottage production.

Second, medium-size and larger progressive firms (and smaller ones in some industries) have the necessary economies of scale

in production techniques and export marketing to develop a competitive advantage in various products in world markets. In countries like Taiwan and South Korea, the rapid growth of relatively labor-intensive exports emanating from these firms pulled labor from less productive uses into higher-productivity jobs.

Finally, all these factors should have beneficial implications for the distribution of income. It can be argued that a strategy to remove the barriers to participation of progressive small and medium firms can result in growth with equity.

Entrepreneurship, learning-by-doing and demonstration effects. Increased participation of small and medium firms will mean that more individuals can develop and utilize their entrepreneurial talents. In countries which export supply trained and skilled workers through emigration, more of the available talent pool will be retained at home.

The existence of a large group of progressive small and medium firms can have a powerful demonstration effect for the rest of the economy. Innovations introduced by the most progressive firms spread in time to the less progressive. In addition, entrepreneurs learn from the success of others. The participation of progressive small and medium firms in economic growth can in this way produce benefits beyond their direct contribution to industrial production.

3. Policy Biases

The failure to realize these advantages in many countries is partly attributable to policies which protect large firms from competition from the up-and-coming progressive small and medium firms and, in some cases, also protect the small, thereby helping to keep them small and unprogressive.

The policies which protect large firms are well known and need only be referred to briefly here. Trade policy (tariffs and quantitative restrictions) is the worst offender. Other pervasive policy biases in favor of large firms include the structure of investment incentives, minimum wage laws (which induce firms to substitute capital for labor) and overvalued exchange rates (which reduce the cost of capital below its social opportunity cost for firms able to obtain rationed foreign exchange or borrow in the international capital market). All these policies induce firms to become prematurely large and capital-intensive.

While large firms receive preferential access to credit, small ones may be frozen out of borrowing altogether or forced to borrow at much higher rates on "curb" markets. This makes it much harder for them to grow.

Some countries, notably India, have matched this kind of protection of large industry with protection of small firms, thus

explicitly promoting a dualistic structure with a "missing middle". More commonly, however, policy promotes this outcome without intending to do so. A "small firm growth trap" is created by policies which impose, in effect, very high marginal tax rates on small firm growth. An example of this phenomenon was provided by EIPA work in the Philippines (Biggs et al., 1987). That country has a minimum wage law, which most small firms evade, and sales and profits taxes, which they commonly do not pay. If, hypothetically, a small firm pays profits tax but its wages are 20 percent below the minimum wage and it evades sales tax, it can grow into the size range in which it must start paying sales tax and comply with minimum wage regulations only by paying a marginal tax rate of 85 per cent! If it cannot raise its profits by more than 85 percent, it will lose money by expanding. This example assumes that the firm already pays profits tax on its net income. If it was initially evading profits tax but had to pay a larger share of the tax as it grew larger, the effective marginal tax rate would be higher still. Besides the tax and minimum wage regulations, there are other regulations which small firms can often ignore or "negotiate," but which become more effectively binding as the firm grows larger. Taking all these factors into account, the marginal tax on firm expansion can easily exceed 100 percent, providing an overwhelming dis-

incentive to enterprise growth.

The basic principles of economic policy involved here are simple. First, tax rates must be set -- and enforced -- at a level which does not unduly discourage firms from paying their taxes and thus permits them to operate, from the start, in the "formal sector" of the economy. Excessive taxation, unevenly enforced, encourages firms to operate "underground" and creates a high barrier to entering the "legitimate" business world. Second, tax policy must pay explicit attention to the relationship between high marginal tax rates and disincentives to firm expansion. Third, minimum wage laws, if enforced, are highly distortionary. They not only encourage firms to cut down on labor use but also discourage firm growth.

Many small firms are established simply to provide their owners with a livelihood comparable to what might have been earned in wage employment. What we have termed "progressive" small and medium firms are different, since the owner/entrepreneur of such a firm typically hopes to expand over the long haul and has formulated a more or less coherent strategy for achieving this objective. The progressive entrepreneur places a high priority on technically efficient production and looks for ways to reduce unit costs and improve product quality. Most fundamentally, the progressive firm tries to anticipate changes in its

environment and adapt to them, predicting and planning for change rather than waiting for changes to occur, then reacting defensively and possibly being left behind by the ongoing process of changing markets and technologies.

Progressive small and medium firms have already achieved a degree of managerial competence and are less likely to benefit from government assistance in this area than from policy and program interventions which enable them to overcome obstacles in the external environment. Such obstacles, and opportunities for overcoming them, must be identified on a country-by-country basis.⁶

4. The Role of Program Intervention

The above argument shows why we believe that policy measures must have a preeminent place in the effort to move towards an industrial structure in which dynamically efficient progressive small and medium enterprises play a significant role. In the absence of an appropriate policy environment, government programs are likely to waste scarce resources and accomplish little. When the policies are right, however, several types of programs can be helpful.

First, becoming outward-oriented and thereby shifting to a more rapid path of economic growth requires a great deal of

structural adjustment. Changes in prevailing price incentives cause industrial enterprises to alter their mix of products, upgrade their production process, explore new markets and invest in new capital equipment. The transition period in which these adjustments are made may be lengthy. Although price incentives and the workings of the market are the driving force behind an efficient adjustment process, appropriate institutions are needed, and these may not exist or function effectively. In such cases, selective government interventions may ease the adjustment process. Examples could include assistance in export marketing, finance (for modernization to meet the demands of the export market and for working capital) and access to specialized production services.

Second, the government has an important role to play in providing services which the market fails to provide or under-supplies. When not all the social returns to specific economic activities can be captured by firms or entrepreneurs, socially sub-optimal amounts will be produced. Examples include R&D activities whose benefits can quickly and easily be used by competitors and employee training programs involving skills used by a number of firms. In such cases, the government can either subsidize firms to provide the needed services in larger quantities or provide the services directly through government programs.

Access to information on export markets is a related example. The high cost of learning about such markets may deter firms from initiating exports, but once the fixed cost is incurred the added cost of diffusing the information to large numbers of firms is negligible. This is a case for program intervention.

Another way that markets may fail to carry out society's will is in achieving an equitable distribution of economic benefits. Particular groups may feel passed over in the process of economic growth. The government may want to address this problem by helping these groups to participate more fully in the growth process or, if that is not possible for one reason or another, to redistribute a share of the gains from economic progress to the less fortunate. The risk here is that governments may sacrifice too much economic growth for greater equity. If the economic pie does not grow, in the end there is not much to redistribute to those in need. A way to avoid this trap is to focus on programs that promote equitable growth. This is what our proposals seek to achieve.

III. THE POLITICAL ECONOMY OF POLICY CHANGE

Altering existing patterns of industrial development often requires the introduction of new policies to provide incentives

and institutions intended to shape the behavior of investors, firms and wage earners. What is often required is "a new policy package, a revamp of basic incentive schemes, and often a trade-off between favored and less favored sectors..." (Cheng, 1986: 3). Achieving significant change in national development strategies is no easy task. Such reforms impinge on important economic and bureaucratic interests, change the distribution of resources in society and alter access to the benefits of public policy. Policymakers who decide the direction and scope of public activities in developing countries weigh the often urgent and well-articulated economic advice they receive from international agencies and their own technical corps against pressing concerns about political stability and bureaucratic compliance. Often the political impediments to reform weigh more heavily with decision makers than the potential economic benefits.

Impediments to the introduction of new industrial policy packages were not always so difficult to overcome. In many countries in the 1930s and 1940s, and in a large number of others in the 1950s and 1960s, planners and policy makers assumed major roles in defining development goals, setting the agenda for industrialization, providing incentives for domestic and foreign investors and creating the physical and financial infrastructure needed for rapid development. Often, these efforts to chart the

course for industrialization met with considerable response, and growth rates in the manufacturing sector were strong for a decade or more (see Hirschman, 1968; 1986). Over the longer term, however, these policies often encouraged inefficient industries, discouraged savings and investment and led to stifling bureaucratic controls. In recent years, a consensus has emerged among many development specialists that exchange rates, interest rates, trade structures, wage policies and private sector/public sector relationships introduced in the past to encourage industrialization now need to be adjusted if rapid economic growth is to resume.

Advocates of reform now call on governments to take the same leadership role in introducing policy reforms that they took 20, 30, 40 or 50 years ago. Yet governments appear to be less able to assume this role now than in the past, despite often greatly improved information, analysis and advice. Today, constraints on altering existing patterns of industrial development are usually defined by the opposition of key economic groups in a society, the need of government to accommodate interests whose support is essential to the maintenance of political stability and the resistance of bureaucracies that have become accustomed to wielding extensive regulatory powers. Moreover, many influential people in developing countries (not least in Latin America) firmly favor

state-led development and find calls for liberalization and deregulation much less attractive than the earlier emphasis on state-building (Lancaster, 1986: 10; Nelson, 1984: 788).

In many cases, past development policies have created interest groups which now fight for perpetuation of their favored positions (see Bates, 1981; Grindle, 1986; Bardhan, 1985). Equally significant is the creation of extensive bureaucratic agencies to promote development. In time, most develop clienteles, regulatory power and patronage-dispensing claims that they are loathe to see diminished through reform. Such interest groups are often able to block reforms aimed at undoing the harmful consequences of the very policies which created the interest groups.

A. Conditions for Reform

Hard as it is to alter industrial policy when economic and bureaucratic beneficiaries of existing strategies have acquired power to resist change, there have been many cases of successful policy reform in developing countries. Although each case of policy reform is unique and country-specific explanations are important for illuminating the conditions surrounding each particular reform effort, there are some general conditions that ap-

pear to facilitate the introduction of significant policy changes and are characterized by distinct ways of managing political and bureaucratic constraints. Three of these merit brief mention here: regime change, authoritarian control and political "engineering."

Regime change -- through a military coup, revolution or negotiated regime transition -- is a powerful facilitator of policy change. A regime change introduces new "rules of the game" for political decision making and the representation of interests. New coalitions of interests acquire power and may be able to diminish the influence of entrenched economic groups. New leaders are often accorded legitimacy or forbearance to change former because leaders of the old regime have lost support and credibility. Space for reform is created because regime changes occur in a context of political and economic crisis; pre-existing policies and the governments that pursued them are often held responsible for creating such crises (see Nelson, 1984). During the early months of new regimes, technical advisors and international lending or donor agencies often have considerable scope for influencing decision makers who are searching for solutions to severe economic problems. Moreover, when the new regime is dominated by the military, considerable potential for repressing opposition can be called upon. Bureaucratic opposition to change is often

overcome through key personnel changes and through the greater centralization of authority that frequently accompanies regime changes.

Some of the most notable instances of policy change in developing countries have resulted from regime changes. Examples include the military coup in Korea in 1961, which initiated rapid export-oriented industrialization (Cole and Lyman, 1971; Cheng, 1986); a military coup in Brazil in 1964, which increased the economy's international competitiveness; the imposition of highly repressive military regimes in Argentina, Chile and Uruguay in the 1970s, which permitted major experiments in trade liberalization; and the coup in Nigeria in 1983, which made it possible to introduce controls on government spending and resume sensitive negotiations with the IMF. An ongoing example is the Philippines, where a revolution culminating in 1985 brought a number of policy reform proposals to the fore. Nicaragua's revolution of 1979 also ushered in significant policy changes, as did the return to democratic rule in Argentina in 1983.

Although regime change creates opportunities for reform, it is not a predictable event on which to pin hopes for policy change. In the first place, many countries for which policy reforms are widely advocated are not highly susceptible to regime changes. Mexico, Venezuela, Kenya and Egypt may be cases in

point. Second, considerable experience in politically unstable countries indicates that regime change does not always result in the imposition of effective government or better policies (see DeCato, 1976). Third, these significant political events can be accompanied by repression of political opposition and abuse of human and civil rights. For these and other reasons, waiting for regimes to change in order to introduce policy reforms is usually not an efficient strategy for bringing about changes in important policies for industrial development.

Authoritarian Control. Authoritarian governments are often credited with great capacity to introduce -- indeed, impose -- significant policy changes in developing countries. Such governments are thought to be hierarchical, centralized and characterized by considerable consensus about the "correct" strategy of development. In such regimes, technocratic elites often have extensive access to decision makers and share an intellectual affinity for strong, centralized governments that appear to be both effective and efficient in exerting control over the economy and society (see especially O'Donnell, 1973). In such cases, the power of the authoritarian state can be enlisted to repress or dominate entrenched political and bureaucratic interests opposed to policy reform. Bureaucracies often become less susceptible to clientistic claims because popular support is less critical to

authoritarian regimes than it is to more democratic systems in which leaders can be voted out of office.

Empirical support for the frequently cited link between authoritarianism and radical departures in public policy is mixed, however. Examples from Latin America, India, Korea, Indonesia and Guinea show that authoritarianism can lead to significant policy change, but many regimes have been described as weak authoritarian systems, incapable of exerting effective power over society or economy (see Callaghy, 1986; Migdal, 1987; Jackson and Rosberg, 1986; Lancaster, 1986; Haggard, 1985). Stronger authoritarian governments, such as those in Latin America, are prone to crises of legitimacy and susceptible to revolution and other pressures for regime transition (see O'Donnell, 1979). These regimes rely on closed decision making and repression of opposition, both of which inhibit the capacity to acquire information and feedback on the impact of their policies on the economy or society. Thus, even when such governments appear efficient in introducing change, their success may be short-lived because of longer-term problems of legitimacy and sustainability. Recent experiences in Argentina, the Philippines, Korea, Iran and India indicate the political fragility of many apparently strong authoritarian regimes.

"Political engineering" is a broad term referring to situations in which a regime does not change and unjust coercion is

not used, yet significant policy change is introduced. Such situations are characterized by the active leadership of policy makers, politicians and reform advocates in creating a coalition of support for policy change and managing opposition to reform. Through such efforts, policy-makers and reform advocates try to lessen societal and bureaucratic resistance. In many cases, political leadership has been effective in selecting strategies and tactics that mitigate conflict (see, for example, Ascher, 1984). Groups of reform advocates can also attempt to influence policy makers and political leaders through mobilization of concerned citizens, such as the efforts of the Institute of Freedom and Democracy in Peru. According to an advocate of this approach, "the route to reform lies in opening up the system of decision making to all" (de Soto, 1987: 19). The objective of this kind of political engineering is to convince decision makers of the political rationality of responding to public demand making and participation. In Taiwan, for example, political engineering through bargaining and persuasion lay behind a shift to export-oriented industrialization between 1958 and 1961 (see Cheng, 1986: 22).

Political engineering may not be a feasible way of introducing policy reform in all countries, but it is a more manipulable and attractive strategy than waiting for, or actively seek-

ing, regime changes or imposing authoritarian rule. In their efforts to bring about change, reform advocates use bargaining, negotiation and sweeteners to soften the impact of new policies on beneficiaries of the status quo (see Nelson, 1984). They can also mobilize mass constituencies for change. In dealing with bureaucratic resistance, the use of strategies to alter existing incentive structures is important. For political engineering to be effective, however, knowledge about how decisions are made and implemented in developing countries is essential. The policy process reveals much about how entrenched political and bureaucratic interests wield power over policy choices and how they express their opposition to reform.

B. The Politics of Policy Making and Implementation

In developing countries decision making tends to be centered in the political executive. Often it occurs in the halls of bureaucratic entities, planning ministries, the executive mansion or political party headquarters. This relatively closed decision-making process and elite-centered politics leave wide scope for pressures to be exerted through informal and non-public channels. "Understandings" with the military about which changes in development policies or budgetary allocations will be tolerated, un

spoken recognition of the disruptive capacities of organized groups or economic interests, the implicit power of foreign interests and private "deals" struck in informal encounters with political leaders often loom large in explaining the political rationale for policy choices. In contrast to the active and influential nature of informal pressures, large-scale organized interest group activity is often elusive in developing countries. Large portions of the population -- peasants and low-skilled workers, for instance -- are generally not organized for sustained political activity and many authoritarian regimes discourage formal interest group or party activity. In some cases, elite interest groups may be well organized and vociferous but wield their real political influence behind the scenes in informal interactions with government leaders.

Policymakers in developing countries often must be extremely sensitive to the popularity and acceptability of the decisions they make because basic consensus about the legitimacy of the regime in power or the appropriate nature of governmental authority is lacking (see Migdal, 1987). As a consequence, many policy decisions are reached because of their symbolic importance for maintaining the regime in power -- nationalist gestures and national security measures are good examples -- while other policies are adopted because they enhance the capacity of the govern-

ment to provide tangible benefits to important groups and interests. Similarly, many policies are not adopted because they threaten major confrontations or the overthrow of a fragile regime, or because they imply time horizons that are unacceptable to politicians primarily concerned about the shorter-term goal of maintaining power. Thus, policy making often "becomes a balancing act rather than a search for optima; a process of conflict resolution in which social tranquility and the maintenance of power is a basic concern rather than the maximization of the rate of growth or some such" (Killick, 1976: 176).

Because policy making tends to be a closed, executive-centered activity, large portions of the population are excluded from influencing the making of laws, decrees and policies that have direct impact on their lives. However, the phase of policy implementation may offer opportunities to reach the bureaucrats charged with pursuing the policies and bring pressure to bear on them. Bending the rules, seeking exceptions to generalized prescriptions, proffering bribes for special consideration, working out a deal, having a friend in city hall -- these are important aspects of political participation in developing countries, which become more significant the more closed the policy making process is. Governments often acquiesce to this informal and unprogrammed allocation of public resources for good reasons. Such par-

ticipation, although it results in considerable "slippage" between the stated policy and what actually happens, may help hold a tenuous regime together. According to Migdal, "[t]he state has become...the grand arena of accomodation" in many countries, whose "local and regional strongmen, politicians and implementers accomodate one another in a web of political, economic and social exchanges" and where "[t]he local stability that strongmen can guarantee...is critical to the overall stability of the regime" (Migdal, 1987: 427).

These characteristics of the policy process in many developing countries -- closed decision-making processes, the importance of informal influences, sensitivity to regime vulnerability and slippage in policy implementation -- affect the capacity to introduce and sustain policy changes. For most reform initiatives, conflict over policy content is inevitable. The identity of those engaged in these conflicts will vary, of course, because policy changes affect distinct interests differently (a devaluation generally favors exporters and harms importers, for example), the capacity of different interests to express their discontent or support varies (industrialists tend to have much greater access to the policy making process than do peasants, for example) and sequences in applying reform differ in how groups are able to adjust to change. Similarly, the arenas in which

conflict is expressed will vary, depending in part on the way policies are formulated and implemented and the opportunities that opponents of reform have to influence the decision-making process and exert pressure to alter policies they oppose. For policies that affect the structure of industrial development -- exchange rate, trade, financial systems and investment incentive policies, for example -- critical arenas for conflict can be anticipated on the basis of such criteria.

In the case of exchange rate policy reform, conflict is likely to be centered on a small group of officials who determine, usually in secret, what the policy is to be, as well as in the reaction of sectors of the population most affected by the impact of devaluation. Thus, altering the exchange rate may be an extremely difficult decision to agree to and will involve considerable discussion, debate and study among high-level officials and their technical advisers. However, once policy makers have reached a consensus broad enough to allow them to make the decision, and the central bank has adopted the change, the major task of reform is accomplished, assuming societal reaction does not topple the regime that introduced the change. Bureaucratic opposition will not be a significant issue in this type of reform because, once agreed to, it requires little administrative activity. Because such a decision is made by a small group of high-

level officials, the reaction of those harmed by it will occur after the decision is made and may threaten the sustainability of the regime in power. Thus, those contemplating exchange rate reforms are likely to be concerned principally about issues related to maintaining political stability and these concerns will be criteria for assessing the questions of whether, when and how such a policy change is made.

Introducing significant reforms in trade policy, particularly by altering tariff structures, will generate both political and bureaucratic opposition. Critical arenas for conflict are likely to be centered in the ministries and agencies responsible for determining the content of trade policy and regulations. Tariff structures in many developing countries favor highly specific types and scales of economic activity; public protest may be minimal because effective opposition is difficult to organize when reform has differential effects on specific interests. In contrast, individual enterprises or groups of firms may have much to gain by exerting influence informally within the decision making and implementation processes, attempting to shape the specific regulations or rates which affect them. Bureaucratic agencies and officials that implement existing trade regulations often have developed extensive discretionary power to issue licenses, grant exemptions, apply rules, set rates and expedite

or delay the movement of exports and imports and may be amassing considerable bureaucratic rents from their control of trade policy implementation. In such cases, both individual officials and entire agencies may well resist conforming to new trade structures, particularly those that liberalize and deregulate trade. Policy reform advocates should therefore anticipate an ongoing set of tasks to monitor bureaucratic performance and ensure that extensive slippage does not occur between a decision to make a change and the accomplishment of the intent of the reform. At this point, administrative structures, bureaucratic compliance and informal arrangements with societal interests have considerable capacity to stymie the reform initiative.

Financial and fiscal reforms -- interest rates, credit controls, the level and structure of taxation -- have important impacts on industrial growth and critically affect broad sectors of the population. To the extent that those who benefit from existing policies are able to mobilize to oppose change, they will probably do so publicly and also through more informal efforts to influence decision makers. Conflict over change is likely to be significant at the time such decisions are made and to focus on the high-level decision makers. Bureaucratic opposition to changes that affect discretionary power to allocate credit or to apply tax regulations may also be strong. As in the case of

trade policy reform, officials and agencies may well resist efforts to diminish their capacity to accumulate bureaucratic rents. Reform advocates must therefore be prepared to work to build consensus among decision-making elites that the reforms are essential for economic development and feasible within a particular political and administrative context and to continue to oversee a process of implementation in which considerable resistance and slippage is likely.

A much easier situation is encountered in efforts to introduce investment incentives. Generally, such incentives do not threaten the position of current beneficiaries of industrial development policies but merely add new groups to those receiving special attention from the government. Such policy changes may be embraced by political leaders concerned about ensuring that their regime has broader political support and to reward new coalition allies. Moreover, bureaucratic compliance is less an issue than with other types of policy changes because investment incentive schemes often provide new clienteles for public agencies empowered to implement industrial development policies. A much more difficult situation is faced when reforms in investment incentives alter existing incentives as well as introducing measures to encourage new departures in investment and production. In these cases, beneficiaries of existing schemes will resist ef-

forts to diminish their favored position. Their efforts to influence policy are likely to be both public and informal, as in the case of financial policy reform.

Political and bureaucratic opposition to reform initiatives will of course differ from country to country, depending on the degree and type of opposition to government policies that are permitted, the extent to which interests are effectively organized, the bargains struck among conflicting interests, the distributional impact of changes and the capacity to engineer outcomes that both permit significant reforms and contain conflict at levels that do not threaten the viability of the reform or the stability of the regime. It should be clear, however, that the conflictful nature of industrial policy reform means that "persuasion of government officials will not be sufficient to ensure the adoption and sustainability of reforms. Relationships of political power and influence among affected groups must also be considered if reforms are to be effective and maintained" (Lancaster, 1986: 21).

IV. CONCLUSION

This essay has dealt only obliquely with the informal sector as such. We have treated the phenomena which some development

analysts and practitioners lump together and characterize as the informal sector as characteristics of underdevelopment which are exacerbated in many countries by ill-advised government policies. We have focused directly on what we see as the main issues.

Urban dualism has labor market and enterprise aspects. In less developed countries, most people work for low wages (in small or large enterprises) or are self-employed at low rates of return, while a few are paid much better wages by larger enterprises or the government. This dualism has long been observed and analyzed by economic theorists (Lewis, 1954; Fei and Ranis, 1964; Jorgenson, 1966). The cure for dualism is development. As the empirical economists have shown, dualism disappears as economies grow and generate sufficient demand for unskilled labor (Kuznets, 1965; Kuznets, 1966; Chenery and Syrquin, 1975; Chenery, 1979). In high-income countries, most people work for large enterprises, where their labor is sufficiently productive for them to be paid a substantial wage or salary.⁷ Although many small enterprises survive in rich countries, most of them aim only at providing a livelihood for their proprietor and his/her family; many fail even to do this, going out of existence after a few years at best. A few, however, thrive and grow, providing not only productive employment but a vital element of flexibility, innovation, and competition to the economy.

Given all this, our proposal is merely the obvious one that governments in less developed countries concentrate on achieving economic development. Development means structural change, but this cannot be forced; it must be achieved in ways that are consistent with efficiency. Small and medium firms have an important role to play, and it is worth ensuring that the policy environment permits them to play it. Moreover, the policy environment which supports the growth of progressive small and medium enterprises is desirable on other grounds, since it happens to be one which is also conducive to efficient industrial growth and structural transformation.

Unfortunately, many developing countries have already committed themselves to other paths, which led them to significant industrial growth for a time but have now come out at a dead end. They now face the problems of policy reform examined in the preceding section.

In the meantime, while industrial policies which will have a big pay-off in the long term are being formulated and pushed through resistant political structures, what should be done about the existing informal sector? One clear point is that "informal" economic activities need not be regulated unless they pose a clear threat to public safety or morality. Often they provide the poor with better income-earning opportunities than wage

employment in unskilled jobs. There is no justification for suppressing them on vague grounds that they are not "modern." There is indeed economic potential in this sector, and more of it will be released if regulation is relaxed. We also support policies and programs to assist the informal sector, but here we have several caveats.

(1) As agents of economic development, very small enterprises are, to put it bluntly, of little interest. Few will grow; most represent the survival strategies of very poor people. Despite the currently popular rhetoric, efforts to assist them are more in the nature of livelihood assistance than of development policy. More significant development efforts are those which focus on achieving structural change and promoting the participation of progressive small and medium firms in that process.

(2) Policies impinge in major ways on the welfare of those who depend for their living on the "informal sector". The most important step that can be taken to assist these people is to reduce policy discrimination against small and "informal" enterprises. Carried to its limit,

this type of policy reform will eliminate dualism itself. The rationale for policy discrimination against the informal sector is weak and based on special class and bureaucratic interests.

- (3) Programs to go further and actively assist informal economic activities face many obstacles, most fundamentally the high transaction cost involved in any activity forced to deal with numerous small-scale clients. The best programs are those which improve the workings of the market -- for example, credit programs providing small sums of working capital on commercial principles modified to fit the circumstances of small producers (see, for example, Patten and Snodgrass, 1987).

FOOTNOTES

1 Respectively, Research Associate, Research Associate and Institute Fellow, Harvard Institute for International Development. This paper was written under the auspices of the Employment and Enterprise Policy Analysis Project, which is sponsored by the Employment and Enterprise Development Division, Office of Rural and Institutional Development, Bureau of Science and Technology, United States Agency for International Development (Grant No. DAN-5426-C-00-4098-0). The views and interpretations in this paper are those of the authors and should not be attributed to the Agency for International Development or any individual acting on its behalf. We thank Jerry Jenkins, Jack Powelson and Bob Young for comments on an earlier draft while exonerating them of any responsibility for the present version.

2 Some "informal" activities in developing countries exhibit high productivity (e.g., self-employed professionals), but these generally represent a small proportion of the total. Many others provide returns higher than the wages that are paid to unskilled laborers. Some may even show average productivity levels that compare favorably to those of many "formal" economic activities. But all have low productivity relative to the potential levels attainable through economic development. It is above all in this last sense that we use the term "low productivity" in this paper.

3 Based on Chenery and Syrquin (1975), Chenery, Robinson and

Syrquin (1986) and Syrquin (1987). For each sectoral component in Table 1, the actual value for a given country is compared to the one predicted from the cross-country regressions of the variable as a function of income per capita and country size. The regressions are estimated from samples of up to 103 countries for the period 1950-83. Average deviations from predicted values for selected indicators (trade and final demand, employment and urbanization, value added) appear in Table 1.

4 A problem arises because the economically active non-agricultural population at the beginning of the period (1950) was twice as large as the labor force in industry. Growth at the same percentage rate (4.1 percent) from these different bases meant that absolute increases in modern industrial employment fell considerably below absolute annual increments in the economically active nonagricultural population. For the modern industrial sector to keep pace in absolute terms with the rising economically active population, it would have had to grow at a rate about one-third faster (approximately 6.3 percent).

5 The statistics in the last section indicated that productivity and wages in urban industry and tertiary employment did not decline generally in the 1950-80 period. But this indication that "soft" employment is not increasing does not mean that a transformation is taking place which makes workers better off.

6 Specific suggestions for the Philippines are made in Biggs, et al, 1987.

7 In view of recent publicity given to the role of small and

medium enterprises in employment creation and other developed countries, it is worth citing data on this point published by the OECD (OECD, 1985: 65). In seven OECD member countries for which data on employment by enterprise size in the entire private sector were available, the employment shares of large enterprises (500 employees or more) ranged from 27 percent in Japan to 59 percent in Sweden. Medium (100-499 employees) and large enterprises together accounted for more than half those employed in the private sector in all countries except Japan, where the figure was 44 percent. In the manufacturing sector the predominance of medium large enterprises was even greater. Large enterprises accounted for 33 percent (Japan) to 71 percent (the United States) of total employment in the 15 countries for which data were available. Medium and large enterprises together made up 60 percent or more of manufacturing sector employment in all these developed countries except Japan, where the figure was 53 percent. In the service sector, large enterprises generally represented 25-30 percent of total employment.

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