The Policy Analysis Needs of a Region-Focused
Small and Medium Enterprise Development (SMFD) Project

By

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I. The Opportunity and Program Framework

The proposed small and medium enterprise development project has its origins in a desire to promote employment in off-farm activities, these being defined as the non-agricultural activities of the agricultural regions of the Philippines. The agricultural regions of the Philippines account for 80 percent of the nation's full-time non-agricultural employment. Central Luzon grew rapidly during the 1970s on the strength of the rapid growth of agriculture. (Gibb, 1974 and 1978). This experience can be expected to be repeated in many of the other agricultural regions durin the 1980s now that so much of the needed agricultural infrastructure is in place.

Even at their present state of development the non-agricultural activities of such regions can be said to constitute large, diversified economies in their own right. Over 50 percent of the labor force in Central Luzon is already engaged in non-agricultural activities, despite an almost complete lack of large scale industry. Many of the other regions are 30-40 percent non-agricultural. They are lagging Central Luzon by approximately a decade.

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These economies expand as a consequence of expansion in their internal markets as agricultural productivity growth raises farm incomes. SME expansion occurs both as a result of increased demand for locally-produced goods and services and as a result of initiation of production locally of goods and services previously imported from Manila, or possibly Cebu. There are relatively few supply-side constraints to such expansions, entrepreneurship, production and design skills, local market information, and even capital, in some sense, being in sufficient supply. The expensions are largely demand-driven which means that policies influencing agricultural growth and the level and distribution of income in the region are crucial determinants of the rate of expansion of SMEs and their employment (Gibb, 1981).

The other area of policy that is believed most important for SME growth in the regions is the question of scale and location biases in public policies - that is, biases which by favoring production that is large in scale and located in metropolitan areas prevent small and medium firms located in the regions from competing on an equal footing in the regional, and even national, market.

A basic program problem in trying to aid SME development in order to promote off-farm employment arises from the fact that there is a sharp distribution in these regions between small and medium industries (SMIs) and the multitudinous small businesses (SBs) producing for local markets (Gibb, 1972). The small businesses are overwhelmingly the most important employing sector. In contrast, the small and medium industries, though they attract considerable attention, account for little employment (less than 5 percent of non-agricultural employment) and often have relatively weak backwards and forward linkages as well. Thus, if an SME development project wishes to truly address the question of employment, it must somehow come to grips with the needs of the small businesses as well as those of the SMIs.

We will argue in this report that maintaining a dual interest in SMI development and in non-agricultural employment generation is possible and that it is best done via an "employment and enterprise policy analysis" component. This is synchronized with the set of technical assistance sub-projects. We will further argue that efforts to deal jointly with employment and enterprise policies will be strongly synergistic, indeed that the reinforcement the two concerns provide each other may be crucial to a successful effort in either area.

II. Policy Issues Neding Examination

Although the structure and trends in employment in the Philippines have been reviewed in detail at various times (ILO, 1974; Tidalgo, 1982), the impacts of the various employment and enterprise policies on employment in the several major affected groups has not been studies systematically. Industrial policies were reviewed comprehensively in the mid-1976) and a comparison review of agricultural policies will be completed shortly (David et. al., 1983). But neither of these reviews had dealt directly with the employment impacts of policies by industry size (small, medium, or large scale) or by functionally-defined sector (especially the non-farm, urban informal, and modern sectors). (See Annex A for a breakdown of non-agricultural employment groups functionally and, in the case of SMIs, by size. These target groups are weighted by employment.) The studies of SMIs have dealt narrowly with manufacturing activities (Andersen, 1981; Pernia, 1982).

The employment and enterprise policy issues of greatest importance to regional growth are the following:

1. Income-related policies, especially agricultural price policies and policies influencing the rural-urban terms of trade. These policies are of equal importance to SMIs and small businesses.

2. Locational biases against SMIs in the regions, especially biases which restrict their access to government-regulated resources.

3. Scale biases, especially policy biases that make it difficult for medium scale industries to compete with large sxale industries.

4. Biases against production for the domestic, as opposed to export market. Although the labor-intensiveness of the exports might be found

to off-set fully any loss of employment in regional SMIs, there would still remain the question of retional bias.

5. Are present industrial promotion policies neutral as regards location in the region? This is the question of geographical dispersion of large-scale industry and introduces the issue of how reigonal SMIs might be linked with growth-pole industries in the region.

6. What might be the most effective approach to distressed enterprises in the regions? Most of them would be SMEs.

The first three issue areas noted above are general in nature and are discussed in some detail in Annex B. They would constitute a fairly large analysis effort that would probably have to be undertaken by a resident team of analysts in Manila. A methodology using Philippine labor force data is available but will require some up-dating with respect to statistical sources. (See Annex C, a proposed "Core Program of Analysis". This program has a proposed duration of at least two years and would follow a"study-seminar-evaluation" procedure that is discussed elsewhere.)

The remaining policy areas, together with the technical studies recommended below, could behandled in a variety of ways, including sub-contracting schemes linked to the several technical assistance subprojects of the SMED project.

The synergy of handling employment and enterprise policy analysis together derives from the interdependence of the two subjects and the difficulty of dealing with each in isolation. Employment policy is clearly of large imprtance nationally but is hard to do anything concrete about. (The World Bank's efforts are assumed to have the factor-price bias issue-that is, interest-rates and foreign exchange rate distortions-in hand.)

Similarly, enterprise analyses focused on SMEs tend to lead to direct efforts at technical assistance to SMIs, but these deal with only a small target group and may not be cost-effective. Dealt with jointly, the enterprise analyses add concreteness to employment initiatives and the employment analyses place SME assistance in better perspective and should result in their being given higher priority.

When the private emphasis is added to this picture, drawing in business associations and the like, the total program possibilities knit together in a considerably more persuasive manner than they have in the past. Policy analysis often completes the set of instruments needed to aid a given target group where policy is a principal constraint on a sector's growth.

III. Technical Studies and Program Design

The policy analysis component should have provision for the undertaking of technical studies which the program's field work flushes out as needing investigation. Most would probably be micro level issues. Most such issues identified during this mission we question likely to be answered during the project paper drafting.

We will emphasize here only the following which are related to the needs of small business in market centers:

1. What is the nature of the financing needs of local businesses? Do rural banks and savings banks at this level have special needs? (I disagree with suggestions that "time may have overtaken the rural banking system" in the sense that mergers and consolidation may now be technically required and desirable.)

2. What is the importance and optimal organization of the housing industry at the municipality level in the regions in the 1980s?

3. What are the financing needs of the small-vehicle end of the transportation industry in the regions? This is a major employing sector with a nature tendency toward owner operation tricycles and jeepneys.

4. Is the appliance industry in an unhealthy competition with the housing industry in the regions, "unhealthy" suggesting the possibility of price-system bias in favor of appliance use now that electrification is increasingly widely available?

See Annex D for a further discussion of these issues.

IV. Program Implications of these Policy Analysis Needs for the Private Sector Initiative

The SMED team visit identified a number of regional needs that depended upon linkages with Manila. In the policy analysis area there are several issues which might perhaps better fit under the PEP project, specially the questions of the impacts on regions of industrial promotion policies and policies affecting distressed industries.

A possible way to approach policy analysis and the private sector initiative in general would be to give the whole effort or broadly regional focus and then develop it along two dimensions - an employment-enterprise dimension and a center-perifery dimension. Organizationally, the private sector initiative would have two principal components - one each for SMED and PEP - plus a policy analysis component able to meet the needs of both. (A sketch of the organization chart and possible activities is attached as Annex E). The distinctive features of this approach would be as follows:

1) The "broadly - regional" focus

The private sector initiative might have a sub-title "employment and private enterprise at the region level". This focus need not be exclusive, but would

concentrate efforts on linkages leading ultimately downwards to broadly - based growth.

2) The employment - enterprise dimension

At a more general conceptual level, employment and enterprise policies can be seen as dealing respectively with labor and capital use, but on a concrete level. Viewed thus, the concern for enterprise policy encompasses a concern for the efficient use of capital and for capital as the key complement of labor. Such a focusing of our concern for enterprise policy would make possible a relatively narrow and purposeful USAID involvement in enterprise policy. (This thinking is developed somewhat further in Annex E.)

3) The center-perifery dimension

We can already point to three Manila-centered concerns that derive from our interest in employment growth in the regions - marketing technology linkages, large-scale industry dispersal, and the most productive use of distressed industry assets in the regions. Placing

these activities under PEP and calling them center-focused is somewhat arbitrary. There is a conceptual benefit, however, to project design, negotiation, and management in having a simple, two-way split that emphasizes the concern for growth in the perifery and the dependence, in both positive and negative ways, of that growth on the center. Finally, note the possibility of suggesting that the PEP component corresponds roughly to the concerns regarding efficient capital use while the SMED component embodies the concerns for increasing labor use and labor productivity.

V. Recommendations

It is recommended that that a policy analysis component be included in the SMED initiative and be used both to support the technical assistance sub-projects and to provide completeness and cohesiveness to the total effort. This component would include:

1) A comprehensive program of employment and enterprise policy analysis, systematically estimating the employment elasticities of the various policies and programs influencing employment generation. (See Annex B) This Program should be completed in approximately two years and then be reviewed as to its past and prospective effectiveness in influencing policy in these areas.

2) A program of analyses of related policy issues such as items 4-6 noted above in Section II.

3) A capability to undertake technical studies, specially those which the technical assistance, sub-projects identify as being needed.

It is further recommended that USAID consider focusing its entire private sector initiative on employment and enterprise issues

as they affect non-agricultural development in the regions. This identification would suggest that private sector activities are central to the solution of center - perifery imbalances in the 1980s and, at a higher level of objectives, to the more efficient use of both capital and labor in the economy. Were this approach adopted, the policy analysis component would be placed at a general level within the private enterprise initiative, providing policy analyses to support both the PEP and SMED components and assuring cohesiveness in the private sector initiative as a whole. This cohesiveness would also presumably facilitate policy dialogue with the GOP by giving our interest in private sector activity specific focus, namely, growth and welfare in the regions.

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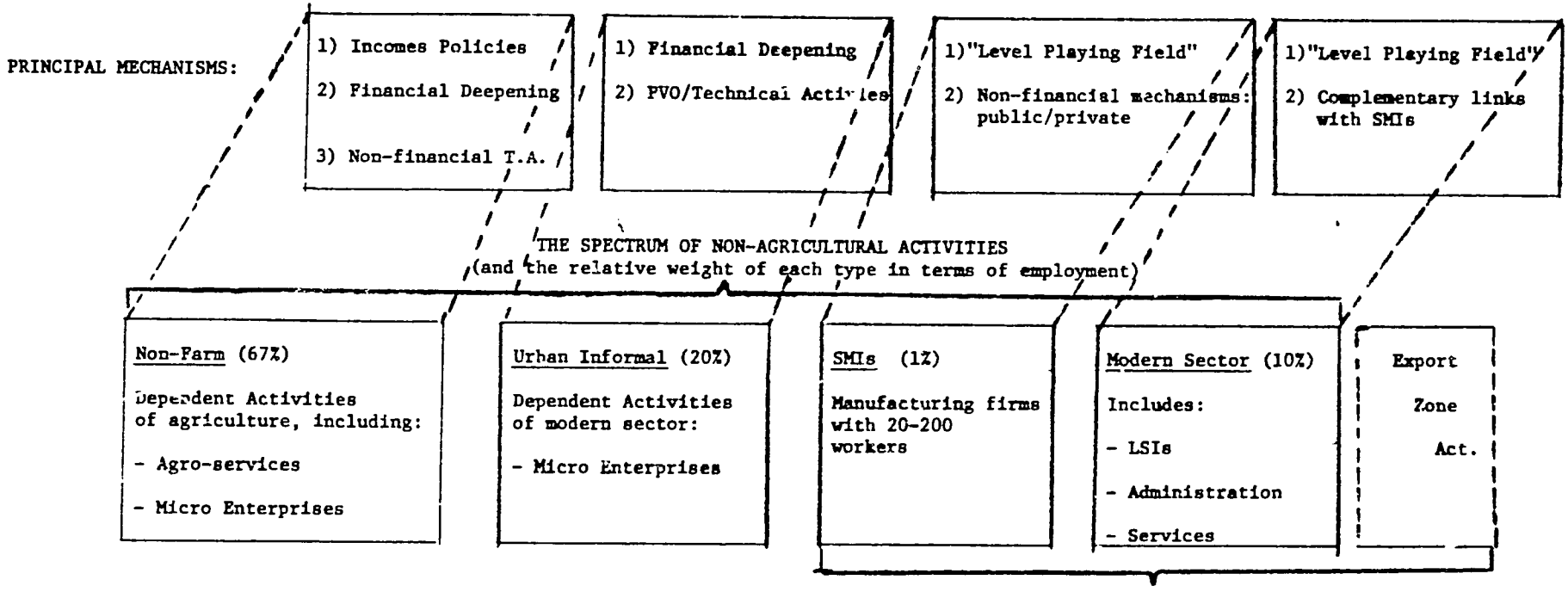
Annex A



"Private Enterprise Development Activities" would deal selectively with these, focusing on:

1) Export Processing Zone
2) The System of Science/Technology Transfer Links

Annex B

Review of Employment-Generation Related Policy Issues

Given the relative weights of the modern, the urban informal, and the non-farm sectors in full-time non-agricultural employment, the principal influences on non-agricultural employment generation are probably (i) the level and distribution of income generated in base industries, (ii) the capital intensity of production throughout the economy, and (iii) the degree of bias in favor of large scale enterprise in public policies.

In contrast, there are a number of other issue areas, such as minimum wage legislation and pay scales of modern sector firms, which are not in general major factors influencing employment generation despite their prominence. In order to underscore the relative importance of the various policy areas, the discussion that follows groups

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1 The modern sector for present purposes is defined as composed of large and medium scale industry plus public sector administrative activities. The urban informal sector encompasses most dependent activities in metropolitan areas, an aggregate that roughly corresponds to small-scale enterprise in those areas. The non-farm sector encompasses all full-time non-agricultural activities in agricultural regions (except for any classifiable as being in the modern sector), an aggregate that roughly corresponds to small-scale enterprise those regions.

the issues under the headings of "capital intensity", "scale bias", "income level and distribution", and "other". Lyn Squire's Employment Policy in Developing Countries: A Survey of Issues and Evidence (World Bank: xford, 1981) provides a recent authoritative review of the evidence on the workings of labor markets. Other sources are drawn on for additional evidence regarding the magnitude of employment generation by sector and the respective roles of small, medium, and large scale enterprises.

The employment and enterprise policy analysis program is focused on non-agricultural employment and will deal only summarily with agricultural employment per se. There are several reasons for this. First, non-agricultural employment is a policy area in need of in-depth consideration by itself. Second, agricultural employment is already well covered as an element of agricultural policy analysis. Third, a reasonable division of labor is possible, leaving consideration of agricultural policies per se -- technical, economic and political -- to the agriculturalist while the non-agriculturalist concerns himself mainly with price system considerations as they effect incomes and with agricultural production's backward and forward linkages to non-agricultural production. This division of labor is consistent with the fact that the level and distribution of income in agricultural largely determines employment generation in the non-farm sector.

I. The Issue of Excessive Capital Intensity

The capital intensity issue principally concerns the overuse of capital goods -- unwarrantedly subsituting them for labor -- as a result of the cost of such goods having been subsidized. (Overuse of credit for working capital purposes is not a significant issue so far as employment generation is concerned.) The issue is one principally of interest rate and exchange rate policies. There is no necessary connection between trade protection and the issue of excessive capital intensity. However, because there is a close connection in the public mind between these questions, it is convenient at the outset to emphasize the separateness of protection as an issue.

A. Protection

The large scale, excessively capital-intensive import-substituting industry has typically also been favored with protection against imports. Strictly speaking, the issue of protection is independent of questions of factor proportions, however. An industry could be protected against imports and, in the absence of factor market distortions, proceed to employ factors in optimal proportions, in a second-best sense. The inefficiencies of resource allocation in such a case would be the result of the nation's choosing to produce a good

in which it did not enjoy a comparative advantage. There is no reason to assume that production in such a case would be less labor-intensive than relative factor scarcities would dictate.

From the point of view of employment generation then, the relevant consequence of protection in a static sense is to produce higher cost products than could be supplied to the market through imports. This is a price-policy issue which relates to demand for labor principally through its effects in reducing the real incomes of the consuming households, a point discussed at length in Section III. (The reasons a nationa may chose protection are considered in the discussion of industrial policy in Section IV.)

B. Interest and Foreign Exchange Rate Policies

The cost of employing capital is subsidized when credit is made available at less than market-determined interest rates. It is frequently the case that all credit extended through the formal capital market carries such an implicit subsidy as a result of central bank interest rate policies. The effect is to create a segmented capital market in which credit is too cheap in the formal market, too expensive in the informal markets, and savings growth is retarded.

Differential foreign exchange rates which favor importation

of capital goods or the inputs that go into their production domestically create a second layer of subsidization of capital goods. In a middle-income nation such subsidies may principally affect equipment use, since physical plant may mainly be constructed of goods of domestic origin. In low-income nations, however, even physical plant may embody a significant amount of imported materials.

As a final general point, we would note that a key area of labor displacement when capital is subsidized often lies in decisions as to how extensively to mechanize materials-handling operations. Whereas as in practice there is often relatively little choice of technique in the core steps of a production process, there is considerable latitude in how materials are moved from operation to operation, beginning in the warehouse and ending in the distribution system. Portering--the low end of the spectrum of materials handling techniques--offers employment to the least skilled segment of the labor force and is capable of providing large amounts of gainful employment up through fairly high levels of development.

Squire couches his review of the evidence on the capital-intensity issue in terms of the capital market in general. He identifies four employment effects of capital market reform, three of which derive essentially from changes in savings behavior and a consequent

impact on labor demand through higher investment, and hence, growth, rates. With respect to capital-labor ratios, the fourth source of employment effects, he concludes-- in what may be an excess of scientific reserve -- that the evidence is ambigous as to the effects of capital market improvement.

Noting that small manufacturing enterprises use four to ten times more labor per unit of capital than large ones and there is "some evidence that value added per unit of capital is higher" in small enterprises (p. 168), Squire concludes that:

> "... small firms are labor intensive and there is no reason to suppose that they are inefficient. [However, there is] no reason to suppose that large - scale enterprises are necessarily inefficient. Nevertheless, if access to credit is extended to all (sic) enterprises at competitive rates, the small - scale sector can be expected to expand in relation to the large - scale sector because the previous differential access to subsidized credit clearly favored larger enterprises." (p. 168)

With respect to employment generation per se, however, he argues that the resulting changes in capitan intensities could either

strengthen or weaken total demand for labor, depending on the elasticities of subsitution, returns to scale, and initial distribution of employment between large and small enterprises (p. 170).

Strictly speaking, Squire is probably correct. However, one suspects it would be easy to construct a model for the "typical" developing nation using plausible assumptions regarding parameters which would give unambigously positive results so far as the impact of changes in capital - labor ratios upon employment generation is concerned. Broadly, what would be required to achieve this outcome are assumptions (i) that large scale enterprises will employ more labor and (ii) that small - scale enterprises will use their increased amounts of capital to enable them to increase the qualifty and breadth of their product lines while not using it for materials handling operations. This latter point, which may be the most important one, edges into the question of dynamics (end entry) as opposed to the comparative statics with which Squire is concerned.

The question of foreign exchange rate policy in this context appears to be essentially a complement to interest rate policy in the sense that subsidies work in the same directions and reinforce capital-intensity distortions. This is due to the fact that large-scale

enterprise probably accounts for a disproportionate share of the demand for imported capital goods, medium-scale enterprise for perhaps roughly its share, and small-scale enterprise for considerably less than its share, measured in terms of either employment or output.

II. Scale Bias: Unequal Access to Subsidies

Government interventions in markets are rarely scale - neutral. Activities which allocate resources de facto ration them, favoring those groups which are most effective in applying for them. In addition, attempts to regulate the acitivities of firms impose differential burdens depending on size and location.

Interpreting all such interventions as subsidies, positive or negative, it is fair to say that in general smaller scale firms are typically placed at a disadvantage relative to larger scale firms with respect to these government interventions. Both static and dynamic employment effects flow from these biases.

It is broadly true that large-scale enterprises have relatively easy access to the subsidies at issue while small scale enterprises have almost none. Medium scale enterprises occupy an intermediate positon.

(i) Subsidized Credit and Foreign Exchange: The application costs, both political and economic, for these rationed resources are typically relatively low for the large firm and prohibitive for the small. Any competition for the large firms comes from medium sized firms who, though at a cost disadvantage, can complete for them. The small firm must fall back on the informal market for credit and on purchases of imported goods from middle-men.

(ii) Subsidized Raw Material Imports: Large scale firms not infrequently are forgiven payment of import duties on industrial raw materials, affording them a cost advantage over smaller producers, both medium size firms that might complete with them directly and small-scale enterprises producing less close subsitutes.

(iii) Taxation: Tax burden tends to vary both by scale and, for the smaller firms, by location. Large-scale enterprises may enjoy tax holidays denied to medium-sized competitors. Even in the absence of tax breaks it is relatively less costly for large firms to comply with

enterprise tax requirements. Small scale enterprises are not subject to quite the same set of biases since the tax system tends to be modified for them. Nevertheless, in the case of those taxes which apply nationally, small enterprise in urban areas, where enforcement is more feasible administratively, may be more heavily burdened than those in agricultural regions where local "accomodations" may be the rule.

The static employment effects of thse biases flow from their causing firms to be lower cost producers at each level than they should be as you go up the ladder. To the extend the cost structures translate into product prices, larger scale firms are being subsidized relative to smaller firms, this presumably permitting them to enjoy a larger market share than they would otherwise have. Correction of these biases will presumably shift production downwards to smaller, more labor-intensive producers.

The dynamic effects arise as a function of expanding market size. Assuming an expanding economy and a "level playing field" so far as public policy is concerned, as the market for a given product line expands one can expect smaller firms to enter, competing with larger firms in niches of the market. The resources govern-

ment tends to allocate are often just those which firms crucially require to move into a new product line -- a particular piece of equipment, a more specialized raw material that must be imported, etc. Where an established de facto system of rationing has rendered shares of such inputs relatively fixed, government interventions have a stultifying effect on both entrepreneurship and smaller enterprise growth. The impaxt on employment generation must be considered serious both in terms of the immediate impact on employment in a relatively more labor intensive sector and in terms of the dampening effect on the overall rate of growth of the sector.

It is a mistake to overlook the importance of expanding market size and the dynamic nature of relations between small, medium, and large enterprise. With the exception perhaps of parts of Africa, nearly all developing nations are moving into a decade of rapid growth of domestic production of consumer goods. A large price in terms of employment generation will be paid by any nation that allows the continuation of past patterns of production that are unwarrantedly concentrated in large-scale, metropol-based enterprise.

III. Dependent Activities and Price Policies Affecting Incomes

Most employment in the urban informal and non-farm sectors occurs in dependent activities. These activities produce mainly wage goods and services, that is, rudimentary-quality consumer goods and services for the localmarket ('Non-tradables") which are not directly competitive in quality with the products of the modern sector. It is convenient for present purposes to identify dependent activities with small-scale enterprise. Whereas in the above discussion of capital intensity there may have been the suggestion that we were principally concerned with manufacturing, in this section it should be noted that small-scale enterprise is alwys used in the generic sense, encompassing commerce, transportation, and other services as well as manufacturing.

Given that dependent activities account for the bulk of non-agricultural employment and that demand for such labor is derived from consumer demand for wage goods and services, it is evident that the level and distribution of income is the most important single determinant of non-agricultural employment generation nationally.

Urban informal and non-farm activities are dependent on different income streams. If we ignore exports and mining activities for the moment, we can say the former depend upon income generated in the industrial and government administration sectors while the latter depend on the agricultural sector, these being the "base industries" of urban and rural areas, respectively.

While all government interventions ultimately have an impact on prices, it is useful to distinguish those which have a relatively direct impact on the level of household incomes and thus on demand for labor in dependent activities.

There are actually three ways in which price policies influence dependent activity employment -- directly through the level of agricultural incomes, directly through the levels of income in the industrial and administrative sectors, and indirectly by effectively transferring income between urban and rural regions through changes

in their terms of trade.

The employment effects of price policies are seen most clearly in agricultural regions. The set of agricultural price policies are those actions which influence the level of agricultural income by changing the prices of either agricultural inputs or outputs. Thus they operate through both the factor and product markets.

Consumer - oriented agricultural price policies, which are common in developing nations, have a negative impact on agricultural incomes and hence on non-farm employment - generation. They typically involve downward pressure on product prices and upward pressures on prices for inputs such as fertilizers and credit. The resulting compression of agricultural income (the income going to the owners of the labor, land, and capital employed) decreases demand for locally-produced non-agricultural products. In addition to this static effect there is the dynamic effect of retarding the growth of agricultural output.

A switch to a set of producer - oriented agricultural price policies tends to have powerful opposite effects since the adoption of land - augumenting technologies is quite sensitive to agricultural price policies. For example, a shift in product price policy alone

will yield not only an immediate static employment effect as the new income (from a constant output) is spent and re - spent locally but will also have a dynamic effect - through an increase in the use of modern inputs in the next period. Agricultural incomes will be higher by virtue of both price and output increased in this nex period. Beyond this rudimentary dynamic effect is the possibly more important impact on the agricultural growth rate of the fact that modern inputs are a generally powerful change agent in the rural economy, raising technical horizons and spurring entrepreneurial instincts.

While the static and dynamic effects on agricultural incomes of moving toward a producer - oriented agricultural price policy are generally acknowledged, this recognition is rarely extended in a focused way to its implications for employment generation in non-farm activities. Were the weight of such activities in total non-agricultural employment adequately recognized, there would likely be significantly more political support for changes away from consumer-oriented price policies.

Non - agricultural price policies for present purposes will be defined as those which have the effect of raising the prices of the outputs of the industrial and administrative sectors or of decreasing

the cost of raw material inputs to them, thus creating biases which raise the income of household providing factors to such productic ("non - agricultural incomes," to maintain the semantic symmetry with the previous section).

The generally pro-urban and pro-manufacturing political orientation of developing nations tends to produce such a set of price policies. They typically take the form of protection of import-subsituting industry (raising product prices); implicit subsidies in such industries to credit, raw material imports, and firms' tax liabilities (reducing production costs), and, in the administrative sector, maintaining an above-market wage structure in public services (see Squire, pp 118-121, 130-132).

The direct employment effect of such biases in non-agricultural price policy is of course to promote excessive employment generation in the urban informal sector. This excessive employment generation is directly at the expense of non-farm employment generation to the extend that the urban - produced goods and services are traded to rural households or embody reduced costs that had to be made up by increasing the tax burden on the rural economy.

Generalizing this latter point brings us to the rural - urban terms of trade aspect of price policy. The terms of trade can be seen as providing a rough summary of the total effects of urban and industrially oriented price policies on employment generation in dependent activities. The net effects of such policies are typically: (i) to raise the prices paid by rural households for urban produced goods, (ii) lower the prices received for agricultural products, and (iii) to overtax rural households through deterioration in their terms of trade; and the latter does so directly. The result is a reduction in demand for non-farm goods and services and hence in employment in producing them. There is a simultatneous increase in urban informal sector employment but it is unlikely that this increase will be of equal proportions since there are likely to be leakages from this rural - urban income transfer into upper income households that do not patronize the urban informal sector.

The political difficulty of attempting to come to terms with rural - urban price policy biases are obvious and daunting. However, when viewed from the point of view of employment (to say nothing of basic human needs), the relative magnitudes involved are compelling - dependent activities account for over three - quarters of non-agricultural employment and non-farm employment is three times as important as is that in the urban informal sector. In other words, price

policy and dependent activity employment are at the very heart of a nation's concern for economic equity as well as for efficiency.

IV. Other Policy Areas Relevant to Employment Generation

It has been noted that the three areas singled out as of greatest priority in terms of their influence on employment generation-- capital intensity, scale bias, and price policies affecting incomes -- are not among the most commonly considered labor market issues and are handled here in a broader than normal context. This underscores several points. First, a concern for non - agricultural employment as a whole forces one to broaden the focus of inquiry well beyond the confines of the urban and export enclaves, indeed to embrace the entire economy. Second, an advantage in titling the area of concern "employment and enterprise" policy is that it requires that the analysis be specific about where and at what scale production is occuring. Lastly, the perspective forces a special concern for the level and distribution of income since it is found that so much of non-agricultural employment is generated in dependent activities.

Having identified the three policy areas and sets of relations that are of the greatest weight quantitatevely for employment generation, we now turn to the set of remaining issues.

A. Protection and Industrial Promotion

Separated from the capital - intensity issue, protection of import - subsituting industries may not be of central importance to employment generation except as it influences the over - all rate of income growth. Import - subsituting industries themselves typically generate less employment either directly or indirectly than is commonly supposed and thus do not in fact weight heavily in the overall employment picture.

Broadly, there are two justifications for protecting a new industry -- the infant industry argument and the diversification argument. The first is generally accepted as an efficient use of resources if the rules are followed, that is, in cases where protection is provided (i) to assure the new industry an economically - scaled market and to cover the "learning - curve " period, (ii) provided the nation can reasonably be presumed to have potential comparative advantage in producing the product. This is an argument for incurring short - run economic costs in order to obtain long - run economic benefits.

The diversification argument in contrast is more often than not a matter of seeking a political benefit at an economic cost. Under

this argument domestic production is promoted and protected for reasons of national security, national pride, parochial politics, and purported dynamic benefits from the "externalities" of industrial growth.

If we accept that the infant - industry and other protection may be warranted, whether for economic or even for social/political reasons, there still remains the problem that it is one thing to support such a policy through a price bias against the consumer but quite another thing to do so in a way that discriminates against other smaller and more labor-intensive potential domestic producers. This is the principal issue that an employmetn - oriented policy analysis unit would have to come to grips with so far as industrial promotion policy is concerned. In theory, there should be level of protection which by itsel would be sufficient to attract potential investors. In practice subsidized interest and foreign exchange rates and freedom from taxation and import duties are widely used to create the required spread between costs and revenues.

Presumably various compromise approaches can be fashioned that spread the costs accross several policy areas. For example, if the probelm is seen as one of attracting a large investment in a leading import - substituting industry, one might argue for providing a relative-

ly high level of protection but a relatively short period of concessional provisions that effectively reduce costs. The reasoning could be that the initial organizing of resources on an unprecedentedly large scale involved start-up costs (but also social benefits) on a scale so large as to require off-setting cost savings. This requirement would be distinct from the price premium the protection was intended to confer to cover risk and initial inefficiency in a more general sense. By this reasoning the cost-reducing concessions could expire after a relatively brief period, say, three years, leaving a protected market which provided a "level playing field" for smaller potential producers in the protected market.

The essential point here is that industrial promotion schemes should be based on a rationale that explicity recognizes the need to move as quickly as possible to a position in which input subsidies are not being provided selectively at the firm level, even though it might be considered desirable to provide continuing subsidies (through protection) at the industry level. (Note that, so far as employment generation is concemed, it could be argued that the cost-reducing concessions' impact was neutral if they expired once the extraordinary costs were no longer being incurred. Estimates of such costs would of course be imprecise.)

B. The Operation of Labor Markets

Squire comes to the perhaps surpr sing conclusion that labor markets in developing nations in general work relatively well and that reform measures do not offer large returns. He singles out the influence of public sector pay scales as the major exception to this generalization but emphasizes that the need for reform is likely to be found most in the conditions that underlie either labor demand or labor supply rather than in the workings of the markets for labor itself. Specifically, he concludes that the markets for unskilled labor tend to approximate competitive markets, especially in rural areas, and that the markets for skilled labor, through also basically competitive, are often distorted by excessively rigid public sector pay scales (which account for the high rates of educated unemployed.) These generalizations are not invalidated by the considerable evidence of exceptions to them. (Squire, pp. 125-133).

(i) Minimum Wages and Unions

Squire concludes that in general minimum wage legislation is limited in coverage and effectiveness (pp. 114, 125) and that reductions in the minimum wage are likely to reduce any excess of labor primarily by

reducing supply, rather than by increasing employment (p. 127, 128). Although the weight of the evidence favors these generalizations, he notes that there is wide variation in country experience and that minimum wage legislation is probably the most important single cause of distorition in the unskilled labor market (p. 109). By and large the minimum wage level is set as a result of political lobbying by unions rather than as the result of collective bargaining (p. 113).

From the point of view of employment generation, Squire's conclusions suggest that in general one would not look to modification of the minimum wage legislation as a way to significantly increase jobs, especially if its coverage is in practice limited mainly to the modern manufacturing sector or to a comparably small area of employment. On the other hand, there could be tactical advantage in a given context to analyzing minimum wage legislation as a way of drawing political attention to the issue of labor utilization.

(ii) Social Security Legislation and the Hiring Practices of Modern Private Sector Firms

Squire concludes that available evidence is insufficient to establish that either of these is typically a distorting influence on labor markets in the sense of raising wages above market determined rates. What evidence there is on social security costs suggests that " the full burden of payroll taxation is borne by labor" (p 118). Similarly, with the exception of small, mining-dependent countries, the evidence suggests that modern sector pay differentials are likely to reflect the heterogeneity of labor rather than market distortions. Here again, there is a presumption that more often than not the amount of employment in the sectors involved is not large or dominating (pp. 114-116, 125).

(iii) Unemployment and the Educated Un-employed

Squire concludes that "unemployment rates for unskilled labor are low in most countries" (p. 125) and that therefore it is often useful to view the problem of unemployment as the problem of the educated unemployed. It is common for there to be a mismatch between the aspirations of educated labor and the supply of modern

sector jobs, including those in the public sector. The hiring practices of the public sector are the major cause of distortion in the market for skilled labor and, hence, of unemployment (p. 109).

Squire notes the solution to the disequlibium in the market for educated labor, so far as the public sector is concerned, principally involves (i) making public sector pay scales more flexible so they are responsive to market conditions, (ii) changing the volume and mix of the output of the education system so it too is more responsive to market conditions, and (iii) adopting measures to increase the rate at which the individual adjusts his job expectations, for example, through information services and employment agencies (p. 130-132).

Strictly from an employment generation point of view, the educated unemployed would not appear to warrant high priority. Although they may be politically votatile and influential, they are not typically a needy group by comparison with others for whom finding employment may be a matter of sheer livelihood. The issues they raise are mainly the long-range ones of civil service and educational reform. On the other hand, they might warrant high priority in a case where conditions were ripe for reform (e.g., where there is a

latent willingness to reduce in-hiring rates, the rate of cost of living adjustments, or other areas where there was inflexibility in the public sector salary structure) and where assistance with policy analysis was needed.

C. Income Distribution Reform and Agricultural Growth.

Given the weight of dependent activities in total non-agricultural employment, reform measures that put a larger share of income into the hands of lower income households would immediately generate new productive employment as the new income was spent on wage goods and services. Analytically there is little doubt about the linkages and it is not difficult to isolate the elasticities involved. The potential for change lies mostly in agricultural land reform but also in labor-intensity and rural-urban terms of trade issues.

Land tenure reform is a key issue in some countries. Could a liberal reform be successfully accomplished, there is little doubt as to its employment impacts--substantial job opportunities would be created in the sector (non-farm activities) that tends to account for over two-thirds of total non-agricultural employment. There are two major obstacles, however. First, there must be the political will to embark on such reform. Second, there is the efficiency-equity trade-off since the short run consequence of land re-distribution is commonly a decline in efficiency and hence in agricultural output and income. Thus, non-agricultural employment could decline

since it is dependent on the absolute amount of income available to wage-good consuming households, not on income shares.

Without pre-judgin the desirability of successful land reform in any given context, it is important to note as Squire does that there may be "the possibility that the efficiency gains claimed by land reform can be achieved by improvements in market operation without reformation of the landownership system. Wherever possible, consideration should be given to: the removal of those incentives--such as subsidized fuel, and overvalued exchange rates--favoring mechanization; the diffusion of public sector investments in irrigation, transport and communications, and extension services througout the agricultural sector; the provision of equal access to credit regardless of farm size; and increased support for agricultural research at both the national and international level. Agriculture offers considerable scope for factor substitution both within and between crops. Indirect employment effects are also important in these countries, more as a result of agricultural than industrial expansion." (pp 164, 165)

As was noted at the outset, the level and distribution of agricultural income should usually be taken as a given in this program of employment and enterprise policy analysis. It is evident, however, that a policy analysis unit would want to follow the course of agricultural policy making carefully and would no doubt often have opportunities to reinforce the efforts of others to liberalize policy in this area.

ANNEX C

Standardized Core Program of Analysis

The core program of analysis identifies the public policies that comprise a nation's employment and enterprise policies in terms of four focused issue areas, distinguishes the six basic affected groups, and estimates the employment elasticity of each affected group with respect to changes in each policy.

1. Issue Areas

Public policies are grouped in the following four issue areas, the first three encompassing the policies which typically are the most powerful in influencing employment generation and industrial structure. The policies in these areas characteristically have dynamic impacts that are as important as their static impacts.

A. Capital-Intensity Biases: covering policies influencing the capital-intensity of production processes throughout the economy, especially interest and exchange rate policies.

B. Scale and Location Biases: covering policies influencing the scale of production and where it takes place, especially policies resulting in unequal access to government-regulated resources.

C. Income Level and Distribution Issues: covering input and output labor market issues, and income distribution reform issues.

2. "Target Groups"

The groups affected by changes in employment or enterprise policies ("Target groups") are distinguished both functionally/geographically (non-farm, urban informal, and modern sectors) and by enterprise scale (small, medium, and large).

The functional/geographic breakdown reflects assumptions (i) that functionally non-farm and urban informal sector activities are the dependent industries, of the economic base activities in agricultural and industrial/administrative regions, respectively, (ii) that geographically these distinctions correspond to the rural-urban distinction as popularly understood, and (iii) that the modern sector functionally is related to the urban informal sector and gegraphically corresponds to a nation's industrial region(s). In certain special cases it is not possible operationally to make all these functional/geographic distinctions but they are conceptually and analytically useful even in such situations. It should be noted that non-farm employment as defined here requires identifying the part of urban employment that occurs in agricultural regions and summing it with rural non-agricultural employment.

Identifying small, medium, and large scale enterprise as analytically useful target groups reflects a number of assumptions about the nature of their outputs, inputs, and locations. The most important are, broadly, that small-scale enterprises produce goods

for local markets, tend not to be directly competitive with the larger enterprises, and tend to operate in largely competitive conditions, being only indirectly affected by public policies. In contrast, medium and large scale enterprises are assumed to be more or less competitive with each other and directly affected by policy measures.

3. Elasticity Estimates

Elasticity estimates of the impacts of policy on employment are of particular value in framing employment and enterprise issues because of their ability to quantify the issues and thus suggest relative weights and policy priorities.

Elasticity estimates in many cases may have to be relatively crude, especially initially. However, in many situations their value will be as much in giving the decision-maker a rough sense of the parameters of the problem as in suggesting the exact outcome of a policy change. In other words, the direction and intensity of the impacts of a proposed change may be more important than its precise magnitude.

4. The Use of Full-Time Employment as An Analytical Variable

The prime analytical variable employed in the core program of analysis is full-time adult non-agricultural employment ("full-time employment" hereafter). Employment analyses are characteristically bedeviled by the ambigities introduced by the inclusion of part-time employment, youths, and unemployment in the statistics being used.

Shorn of these elements, employment statistics provide a relatively reliable, available, and disaggregated set of data with many attractive characteristics.

In general, full-time employment can be taken to reflect gainful employment, can be disaggregated geographically and by sex, and can be analyzed functionally in agricultural regions since non-agricultural activities there are the dependent industries of agriculture. Disaggregated by industry such full-time employment can be used in a variety of ways in analyses of growth and structural change.

The key characteristic of full-time employment for the core program of analysis is in its ability to place activities in agricultural and industrial regions on a roughly equal footing. Squire observes that employment in services and the informal sector is not generally of lower productivity than that in other sectors (p. 36) and this conclusion often can be extended to full-time adult non-agricultural employment in rural areas. There has always been an index number problem in making comparisons between rural and urban activities since nominal wages (and the cost of living) in the former tend to be lower than in the latter. This has commonly caused non-farm employment to be interpreted as being of lower productivity than urban informal sector employment in essentially similar activities. Employment data, when narrowed to full-time adult activities, largely circumvents this problem and places rural

and urban activities on a comparable basis. Inter-sectoral analyses of employment generation in the non-farm, informal, and modern sector are then possible.

The final characteristic of full-time employment as an analytical variable is its ability to serve as a common denominator between labor force and enterprise analyses. Enterprise data can be interpreted in the perspective of non-agricultural employment as a whole and labor force analyses can be strengthened by knowing the scale and characteristics of the employing enterprises in many sectors. The employment and enterprise policy analysis program will be considerably strengthened both by these enriching linkages and by the single-valued focus which this common denominator gives the program.

ANNEX D

Policy Analysis and Aiding Small Businesses in Market Towns: The Case of Housing, Tricycles, and Appliances

The recommendation that studies be undertaken regarding the provision and/or financing of housing, tricycles, and appliances in the regions is rooted in observations of disturbing trends in these areas since the early 1970s. The housing and tricycle issues are ones of centralization; appliance financing illustrates a feedback loop from electrification that is instructive and in addition may warrant policy attention.

The housing and tricycle issues offer case studies in which events in important areas have gone precisely in the wrong direction. In each case instead of local capacities having been developed, central government interventions have dampened growth in a manner both inefficient and inequitable.

The housing industry in and around agricultural market centers is an important local employing activity. It has five somewhat independent components - the sash works producer who makes windows and doors, the iron works which makes security grills and fences, the hollw block manufacturers, the labor (construction) contractor who does the construction, and the various sources of supplier credit which finance the housing up-grading.

Ten years ago this was a vibrant, expanding area of activity in Central Luzon. Casual observation in Region VI suggests housing should see similar rapid expansion in the other regions of the Philippines in the 1980s, providing invigoration to employment, entrepreneurship, financial development, and the regional economy in general. There is evidence that

this broad and gainingful source of employment and growth is being pre-empted by stultifying central government involvement in three areas - rural Bliss projects are providing subsidized housing to middle (and upper) income families, housing components are being manufactured in a 600-700 man money-cow operation in Novaliches instead of locally, and mortgage financing (mainly to government workers) is being provided by DBP as well as by GSIS and SSS. None of these tendencies has the slightest justification.

In assessing the technical direction in which the housing industry should proceed, special note should be made of the key role of the local banker and hence the interdependence of employment generation in market towns and financial development. First, mobilization of savings locally is the obvious answer to the need for "mortgage" finance. Note that in rural areas one does not construct a house so much as proceed with a series of "projects" up-grading the house. This is a systematic pattern which proceeds in steps, each of which require only a 2-3 year loan. Second, focusing on the supplying enterprises, the growth of sash works, iron works, and hollow block production can effectively be promoted by consumer loasn extended to the buyer. Third, the progression of the labor contractor upwards into a construction firm is an important pattern of local entrepreneurship development.

We need not bother tracing all the likely deleterious economic consequences of interventions into this picture which bias towards upper income groups, discourage the development of local savings institutions, produce components, elsewhere inefficiently, and no doubt in places use large-scale construction techniques and contractors on the 6 acre Bliss

sub-divisions. Suffice it to say a policy analysis study of housing-related programs' impact on regional employment generation in small businesses would be likely to recommend some changes.

The tricycle story is brief. Before, the motorcycle dealer financed tricycle purchases over 24 months with a 50 percent downpayment and few delinquencies. Now the DBP is into tricycle loans and has repayment problems. The financing before was extended by dealers in the province capital. The obvious next step was for local lenders to take over this secured financing. Instead, the financing source moved upstream, into the hands of the DBP. A study would very likely suggest the DBP should get out of both housing and tricycle/jeepney financing in agriucltural regions.

The appliance issue areises from reprots that rural electrification has caused appliance sales to loom in Central Luzon and has had a depressing effect on housing up-grading acitivities. This interdependence is logical if true. The suggestion here is that appliance importation, production, and consumer finance might usefully be investigated to see if policies are biased in their favor. Even if no such biases were uncovered, it would provide an interesting study of the interdependence of a foreign exchange and capital-intensive product line and a labor-intensive, dispersed, locally-biased activity.

As a finally comment I would simply re-emphasize the extreme importance to small business and employment in market towns of housing and savings mobilization activities. The present level of government invovlement is distressing enough without contemplating the damage that may het be done in an area that should provide much growth, employment, and local vigor in the regions in the 1980s.

Proposed Program Framework:

Annex E

PRIVATE ENTERPRISE AND EMPLOYMENT GENERATION INITIATIVE (REGION FOCUSED)

Cross References: CDSS - Off-Farm Employment
Theme/Emphasis - Private Enterprises

Policy Analysis and Technical Studies Component

- sited at PIDs of NEDA
- macro/micro policy analysis

Private Enterprise Promotion Component

Activities

1. Maximize productiveness of assets in regions (distressed industires).
2. Dispersion of industrialization to regions.
3. Technology & Marketing Linkages
   - nationally (to regions) - NSTA
   - internationally
4. Other

SMED Component

Sub-projects

City Focused
1. Industrial Finance Coordination & Training
2. Technology & Marketing Linkages
   - thru associations
3. Micro Enterprises Assistance

Market Center Focused
4. Local Banking System Initiative
5. Technical Assistance to Small (Local) Businesses Association Outreach