

Necessity vs. Opportunity Entrepreneurs in the Informal Sector

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Some informal or unregistered businesses are established to take advantage of business opportunities (opportunity firms) while others are established because the owner cannot find a satisfactory job (necessity firms). Comparing opportunity vs. necessity informal firms in Africa, this note finds that opportunity firms are more efficient and larger. They are also more likely to use external finance, and suffer less from infrastructure bottlenecks such as power outages. However, all these differences apply to the manufacturing sector alone. With the exception of having more educated managers and more businesses located outside than inside household premises, opportunity firms in the service sector are not too different from the necessity firms in the same sector. In short, the motivation behind starting a business influences the performance of informal manufacturing firms but has little effect on the performance of informal service firms.

Schumpeter's idea of an entrepreneur is one who is dynamic and willing to take risks to exploit existing business opportunities and create new ones. However, many businesses in developing countries are established not to exploit business opportunities but because the owners cannot find satisfactory jobs. This is especially true for the informal sector, the focus of this note. For example, a survey of informal (unregistered) firms in Côte d'Ivoire, Madagascar and Mauritius conducted by the World Bank's Enterprise Surveys in 2009¹ shows that 39 percent of the firms were established because the individual owning the single largest share of the firm (henceforth, largest owner) could not find a satisfactory job (necessity firms or, equivalently, necessity entrepreneurs), while the remaining 61 percent were established to take advantage of business opportunities (opportunity firms or, equivalently, opportunity entrepreneurs). Using these data, this note compares opportunity vs. necessity firms with respect to structure, performance and problems faced when doing business. The comparison is useful for a variety of reasons. First, significant differences between necessity and opportunity firms in how they operate and the sorts of problems they face may signal inefficiencies due to the underlying motivation for starting a business. Such possible

motivation-related inefficiencies do not necessarily go away by getting the informal firms to register—the usual policy prescription for the informal sector. Rather, what may be required are wage jobs for the necessity entrepreneurs. Second, anecdotal evidence suggests that informal firms face numerous problems, for example, in accessing credit and benefiting from government programs because of their unregistered status. Policies aimed at bringing the informal firms within the fold of the formal or registered sector can be better targeted toward necessity vs. opportunity firms depending on how the costs and benefits of registering vary across these firm groups. Third, the choice of becoming a necessity vs. opportunity entrepreneur may reflect underlying differences in the level of education or entrepreneurial skills of the individual. If this were true, then the extent of the problem entrepreneurs face in accessing credit or obtaining a power supply, for example, may be different for opportunity firms than for necessity firms. Policies aimed at providing a better business environment for informal firms should be adjusted to address the underlying motivation for starting a business (see, for example, Adragna and Lusardi 2008; de Mel et al. 2008).

What to expect from a comparison of opportunity firms vs. necessity firms is not immediately clear. On the

one hand, opportunity entrepreneurs might be better motivated and more skilled at running a business; therefore, such entrepreneurs should face fewer problems in running a business and also perform better than necessity entrepreneurs. On the other hand, informal businesses usually operate on a small scale involving simple business activities. Therefore, it is possible that entrepreneurial skills and the underlying motivation for starting a business may not matter as much to the functioning of informal businesses. The issue is best treated as an empirical one.

The results discussed below are mixed. That is, opportunity firms perform better than necessity firms along some important dimensions, but there is no difference between the two along other dimensions. More importantly, where differences do exist between the two firm groups, they are largely restricted to the manufacturing sector.

It seems that the motivation for starting a business does not have much effect on how firms in the service sector operate and perform.

Opportunity firms are more efficient than necessity firms

On average across the three countries, total sales in a regular month for an informal firm run by an opportunity entrepreneur equal US\$304 or about 1.7 times the same for an informal firm run by a necessity entrepreneur. While the former is higher than the latter within various sub samples, there are significant differences in the magnitude of the difference. Total sales of an opportunity firm are 2.8 times the total sales for a necessity firm in the manufacturing sector, 1.3 times

in the service sector, 2 times in Mauritius, 1.4 times in Côte d'Ivoire and 1.2 times in Madagascar.² Somewhat surprisingly, there is little difference in total employment between necessity firms and opportunity firms. These findings imply that output

per worker, a measure of firm efficiency, is much higher among opportunity firms relative to necessity firms. The difference is most pronounced in the sample of manufacturing firms where opportunity entrepreneurs generate 3 times more output per worker than necessity entrepreneurs compared with a much smaller figure of 1.3 times in the service sector (figure 1).³ These differences in efficiency levels continue to hold even after accounting for differences between necessity and opportunity firms in firm characteristics such as age of the firm, managerial experience, difficulty in accessing finance, electricity usage and country- and sector-specific factors. Unobservable factors

associated with the motivation for starting a business could be the reason for the stated differences in efficiency levels.

In the service sector, opportunity firms are more likely to have educated main decision makers than necessity firms

The relationship between the educational level and the motivation for starting a business in the informal sector is not obvious. A lack of jobs in the formal sector may force individuals to temporarily work in the informal sector (see for example, Tokman 2007; Fields 2004). If the more educated people have greater aspirations for formal jobs, one may expect necessity entrepreneurs to be more educated than opportunity entrepreneurs. However, the informal sector may serve as a stepping stone to formal business ownership (see for example, Bennett and Estrin 2007; Bosch and Maloney 2007). If the more educated are more aware of business opportunities, as is likely to be the case, one may expect the opportunity entrepreneurs to be more educated than the necessity entrepreneurs.

Our data show mixed results that vary sharply across manufacturing and service sectors (figure 2). Overall, necessity firms are more likely to have educated (secondary education or higher) main decision makers than opportunity firms, a finding largely confined to the service sector. In fact, with the exception of Côte d'Ivoire, manufacturing firms show a somewhat greater likelihood of having educated main decision makers among opportunity firms than among necessity firms.⁴ A possible interpretation of these findings could be that educated individuals are more hopeful of finding a job in the formal sector than uneducated individuals and hence may choose the service sector, which is known to have lower entry and exit costs than the manufacturing sector.

Other firm characteristics, including the age of the firm,

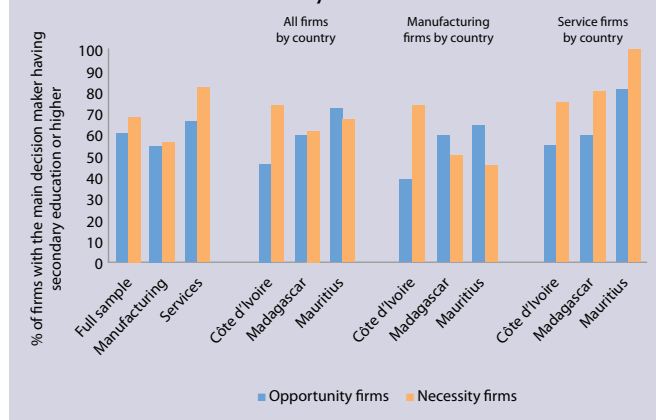
An average worker in an opportunity firm produces twice as much as a worker in a necessity firm. The multiple increases to 3 times for firms in the manufacturing sector.



Source: Enterprise Surveys.

Educated implies that the main decision maker has a secondary education or higher, while Not educated implies the rest (primary or no education). Female owner implies that the firm has at least one female owner.

Figure 2 Motivation for starting a business and education level are related differently across sectors



Source: Enterprise Surveys.

managerial experience, the gender of the largest owner, proportion of sales to final consumers vs. intermediaries and whether the firm is located within or outside the household premises, seem to vary little with the underlying motivation of starting the business.

In the manufacturing sector, opportunity firms have better access to electricity than necessity firms do

Compared with necessity firms, opportunity firms are more likely to use electricity for their businesses and also face fewer losses due to power outages. However, these differences are entirely limited to firms in the manufacturing sector. Service sector firms show the opposite trend although not a strong one. For example, 73 percent of opportunity firms vs. 63 percent of necessity firms in the manufacturing sector use electricity. Corresponding figures for service sector firms equal 53 percent and 55 percent, respectively. Similarly, in the manufacturing sector, losses due to power outages for opportunity firms average 2.3 percent of the annual sales of a firm as compared with 5.9 percent for necessity firms. In contrast, opportunity firms in the service sector show higher losses at 4.2 percent compared with 2.2 percent for necessity firms although this difference is not statistically significant. The use of other infrastructure services, such as e-mail and cell phones, is roughly similar for necessity and opportunity firms irrespective of the sector they belong to.

Access to finance is better for opportunity firms than for necessity firms in the manufacturing sector

Anecdotal evidence suggests that access to finance is one of the biggest problems faced by informal firms. Our data also show that more than 53 percent of the respondents rank access to finance as the most important obstacle to

their businesses from a list of 7 obstacles, which includes (other than access to finance) access to land, corruption, crime, electricity, political instability, and transport.

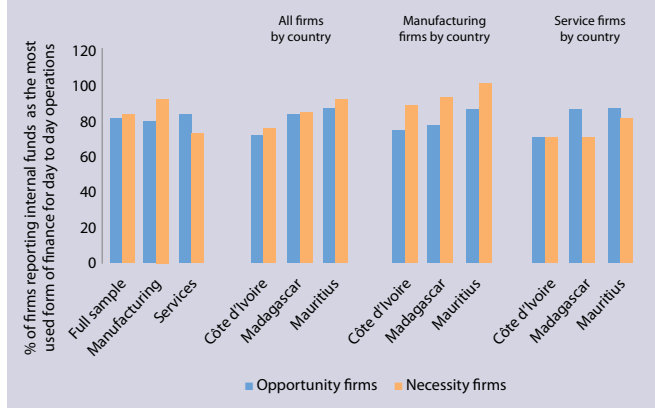
Overall, opportunity entrepreneurs have better access to financing and banking than necessity entrepreneurs do. However, this distinction between opportunity and necessity entrepreneurs is largely confined to manufacturing firms. For example, in the full sample, 39 percent of all firms have a bank account for running their business with the figure varying between 43 percent for opportunity firms and 33 percent for necessity firms. Within the manufacturing sector, these figures equal 38 percent for opportunity firms as compared with only 24 percent for necessity firms. Corresponding figures for service sector firms equal 47 percent and 45 percent, respectively. Similarly, among the firms that have a bank account, 72 percent of opportunity firms in the manufacturing sector and 42 percent of the necessity firms have business accounts that are separate from the household account. For the service sector firms, the corresponding figures are 63 percent and 69 percent, respectively.

A similar picture emerges in the use of internal vs. external funds for the day to day operations of businesses. More than 81 percent of the firms in the full sample report using internal funds (retained earnings of the firms and/or personal funds of the owners) as their most important or most commonly used source of finance. The percentage does not vary much between opportunity and necessity firms in the full sample (81 percent vs. 83 percent). However, in the manufacturing sector, fewer opportunity firms, relative to necessity firms, report using internal funds as their most important source of funds (79 percent vs. 92 percent). In contrast, in the service sector, internal funds are more prevalent as the most important source of finance among opportunity firms as compared with necessity firms although this result is driven almost entirely by a single country, Madagascar (figure 3).

Opportunity and necessity firms differ in their location inside vs. outside the household premises, but only within the service sector

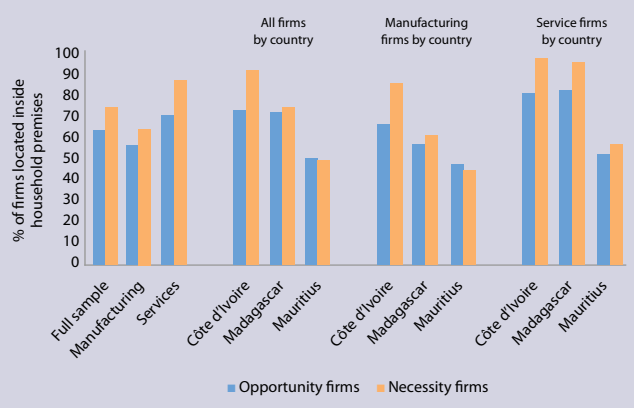
Available evidence suggests that a substantial proportion of informal businesses operate from inside the household premises than from outside the household premises. One reason could be that working from home (inside the household premises) eliminates the cost of renting or buying land outside, which may be particularly attractive to necessity entrepreneurs who hope to find wage-earning jobs in the near future. Working from home also allows greater flexibility in balancing work and family life, which is particularly important to women entrepreneurs in most developing countries. While these reasons suggest that working from home may be efficient and even desirable, it is possible that working from home could be due to the lack of resources (to set up an establishment outside household premises). It

Figure 3 Internal funds are the most used source of finance for the day to day operations of firms



Source: Enterprise Surveys.

Figure 4 Location of business inside vs. outside the household premises



Source: Enterprise Surveys.

may also lower business efficiency and may signal that the business activity is only tangential to other household duties.

We find substantial evidence of home-based businesses in our sample (figure 4). About 63 percent of opportunity firms and 74 percent of necessity firms are located inside the household premises. As figure 4 reveals, this difference between necessity and opportunity firms is largely limited to the service sector firms. For example, 82 percent of opportunity firms as compared with 95 percent of necessity firms in the service sector are located inside the household premises in Madagascar. Corresponding figures for Côte d'Ivoire are 80 percent and 97 percent, respectively. With the exception of Côte d'Ivoire, there is little difference in business location across necessity and opportunity firms in the manufacturing sector.

Notes

1. Data and sampling methodology are available at www.enterprisesurveys.org.
2. Throughout the note, the service sector includes construction. The construction sector constitutes 1.03 percent of the sample and excluding this sector does not make any significant difference to the results discussed.

3. The difference in the output per worker between necessity and opportunity firms in the service sector is not statistically significant whereas for the manufacturing sector it is significant.

4. Information on the level of owners' education is not available. The main decision maker is also the largest owner for approximately 95% of the firms.

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