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The Lessons from DECFP Impact Evaluations

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Our latest note examines whether labor market imperfections stop microenterprises from growing, using an experiment that provided wage subsidies to small firms to help them hire workers

Are labor market imperfections the reason so few microenterprises hire workers? An experiment in Sri Lanka suggests they are not.

Suresh de Mel, David McKenzie and Christoper Woodruff

The majority of enterprises in many developing countries have no paid workers. Previous work providing capital grants to microenterprises has found long-term impacts on firm profitability and survival, but that capital alone was insufficient to get these firms hiring workers.

Do labor market frictions prevent more of these firm-owners from hiring workers? In the presence of training costs, search and supervision costs, regulatory distortions, and other frictions, firm owners with the ability to grow may not hire workers, even when doing so would be profitable in the long-term. As a result, their firm size would be inefficiently small.

Wage Subsidies to Microenterprises

We provided a temporary wage subsidy to owners of microenterprises in Sri Lanka to encourage them to hire a new worker. The subsidy was for approximately half the cost of an unskilled worker, and lasted six months, with an additional two months of subsidy at half this amount.

If firms are constrained from hiring workers because it takes time to train them to become productive, or because it is costly to search for and identify good workers, or if it takes firm owners time to learn their own entrepreneurial ability, then this short-term subsidy could lead to long-term increases in firm employment.

Data and Experimental Design

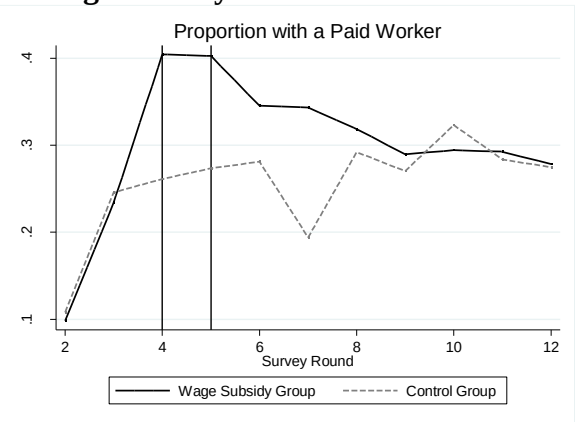
We work with a control group of 286 microenterprises and wage subsidy treatment group of 250 microenterprises in three urban areas of Sri Lanka. These firms were all run by men, only 11 percent had any paid workers to begin with, and they averaged US$130 per month in profits. Additional groups were given the wage subsidies together with business training or a savings intervention to determine whether complementary interventions were needed for firms to realize the benefits of wage subsidies.

The study began in 2008 with a baseline survey, and then tracked the firms through 12 survey rounds through 2014, enabling us to measure the dynamics of adjustment over a period of four years after the subsidy ended.

Results

- Figure 1 shows the key result. 24% of firms take the subsidy to hire a worker, resulting in an increase in employment during the subsidy period. However, once the subsidy ends, firms fire some workers, others quit, and there is no long-term employment impact.

Figure 1. Dynamics of Adjustment to Wage Subsidy



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- The new firms induced to hire workers because of the subsidy are smaller and less profitable than the firms in the control group that hire workers. The subsidy does appear to have provided these firms with additional funds, which helps them survive: we find the subsidy increases the likelihood of still running a firm four years later by 5.8 percentage points.
- We find no significant impacts of the subsidy on firm profitability and sales. The return to the additional labor appears similar in magnitude to the subsidy offered, suggesting additional workers bring no more value to the firm than their unsubsidized labor cost.
- The effect is no larger when business training or a savings intervention are provided, suggesting the lack of impact is not due to the lack of complementary skills.
- Detailed survey questions suggest that firm owners can fill vacancies reasonably quickly, that it usually takes only a month to get the worker up to speed in the new role, and that lack of access to capital does not seem to be the reason few firms are hiring.

Policy Implications

Taken together, our results suggest that the labor market functions with modest frictions for these firms, with hiring frictions not the main constraint to firm growth. This then raises two issues for policy:

To what extent do these results generalize to other settings? We suspect that many characteristics of this labor market hold in most urban areas in developing countries. Workers remain unregistered and hiring is generally unregulated. The work performed by employees in small enterprises involves relatively more brawn and less creative energy. Employees are hired from local areas and there is usually a low degree of separation between employer and employee before hiring. However, we do note that generalized trust appears higher in Sri Lanka than many other developing countries, perhaps lowering one potential difficulty in hiring a worker.

If capital grants and wage subsidies don't cause firms to hire, what will? Our results are consistent with a Lucas (1978) model of firm size, in which firms are small because the productivity of the firms and entrepreneurial ability of the owners is low. This suggests four directions for policy: (i) from a social protection viewpoint, noting that relieving capital constraints may increase the incomes of these owners, even if they don't go on to hire others; (ii) working towards ways to better identify the subset of firm owners who may have more capacity to grow; (iii) developing better ways of building entrepreneurial capacity given the mixed results from business training; and (iv) continuing with policies to help develop the growth of larger firms which can eventually hire these owners as wage workers.

For further reading see: Suresh de Mel, David McKenzie, and Christopher Woodruff. (2016) "Labor Drops: Experimental Evidence on the Return to Additional Labor in Microenterprises." World Bank Policy Research Working Paper no. 7924

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