

Assembling computers in China.  
Jobs are drivers of development  
and pillars of resilience for people.

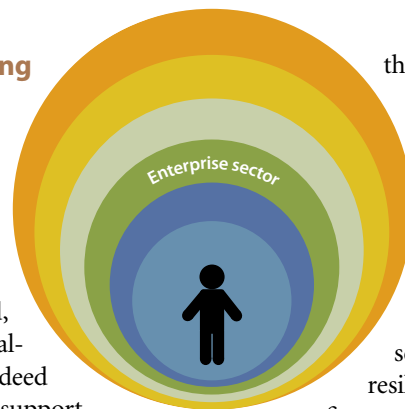


## Fostering resilience and prosperity through a vibrant enterprise sector

### Creating jobs and supporting innovation

The fear of losing or not finding a job is a primary concern for most people. About three-quarters of respondents in developing countries worry a “great deal” about being unemployed, according to the latest World Values Survey. Having a job is indeed valuable: it produces income to support consumption and to help meet important goals, such as providing education, health care, and assets for family members. A job also contributes to self-esteem, a sense of personal security, and even social cohesion.<sup>1</sup> As discussed in previous chapters, these benefits are pillars of resilience and prosperity for households and communities alike.

Not all jobs are the same for purposes of risk management, however. From the perspective of workers, jobs that provide secure and increasing income and a safe working environment are preferable to jobs that do not carry those benefits. Moreover, jobs that produce goods and services that consumers want and can rely on and jobs that respect and conserve the environment are better from society’s perspective. Where can these good jobs be found? This chapter argues that a vibrant enterprise sector is best situated to provide such jobs through its potential to mitigate the risk of unemployment, reallocate resources to create opportunities, and contribute to worker, consumer, and environmental protection. The chapter further argues that two characteristics—*flexibility* (the capacity to adapt to changes to



the potential mutual benefits of workers and firm owners) and, gradually, *formality* (abiding by sensible laws and regulations)—can greatly help enterprises support people’s risk management.

Two examples, continents apart, illustrate how flexibility and formality can improve the enterprise sector’s capacity to foster people’s resilience and promote prosperity. The first example illustrates the importance of flexibility. In Europe, Denmark, Germany, and Spain are among the many countries hit hard by the recent global economic and financial crises: Denmark from an overheated labor market, Germany from a shock to global demand, and Spain from a popped real estate bubble. By the beginning of 2013, more than 25 percent of Spain’s labor force was unemployed. Denmark’s unemployment rate also increased, but to a much lower 7.4 percent. In Germany, the rate was just 5.3 percent.<sup>2</sup> Many factors explain the different experiences of these three countries. For one thing, the shock that hit Spain was larger than those affecting Denmark and Germany. But explanations of the widely different unemployment outcomes should also consider the flexibility of the labor markets in those countries. Labor market reforms in Germany helped moderate wage increases before the international crisis and enabled employees and firms to adjust hours worked through work sharing without the need for layoffs. In Denmark, job separations were high, but unemployment spells were short and eased by a robust safety net and retraining programs for the unemployed. In Spain, in contrast, where a high

percentage of the workforce was employed in the hard-hit construction sector, stringent employment regulations with significant severance costs, along with other structural factors such as the relatively high share of unskilled young labor, have added to the high and persistent unemployment.<sup>3</sup>

The second example shows the benefits for enterprises of becoming formal. In Peru in recent years, informal mines have sprung up in response to rising gold prices. Ignoring existing regulations, these informal mines have caused significant deforestation. The mercury used in the extraction process has contaminated rivers and the atmosphere and threatened human health.<sup>4</sup> In the La Libertad region, the Poderosa Mining Company took an innovative approach to the problem after informal miners invaded one of its mining concessions. The company began to formalize the invading miners, signing agreements that allowed them to continue mining under its direction. The agreements, which meet international environmental management quality standards, have increased the small miners' income and decreased the harm from deforestation and mercury contamination.<sup>5</sup>

These two stories convey the chapter's main message: flexibility and formality enhance the enterprise sector's ability to contribute to people's resilience and prosperity. An enterprise sector that is flexible is more capable of responding to shocks by reallocating resources within and across enterprises and of innovating in an ever-changing world. An enterprise sector that is formal is better situated to take advantage of legal protection and contract enforcement and to make better use of public infrastructure. In addition, formal enterprises can be more easily held accountable for their impact on worker safety and on consumer and environmental well-being.

There are both synergies and trade-offs between flexibility and formality. In countries with responsible and strong state institutions and streamlined regulations, formality enhances flexibility. In countries with weak state institutions and cumbersome regulatory regimes, however, the cost of formality can be too large for the majority of enterprises and workers. In this case, "informal is normal," and informality is a means for the economy to achieve a certain degree of flexibility and for workers to access a practical safety net.<sup>6</sup> A diverse array of workers and enterprises then remains informal because they are excluded from or choose not to join a formal sector that offers limited benefits.<sup>7</sup>

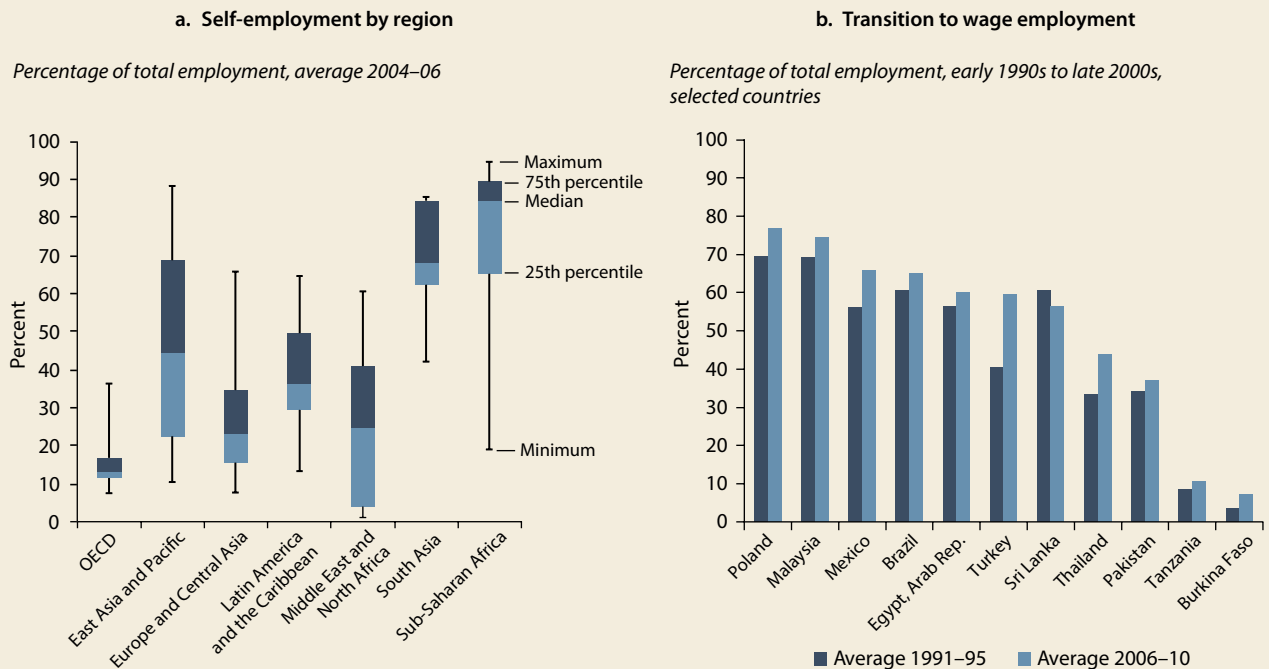
Informality is often a second-best response, however. The majority of the poor work in the informal

sector out of necessity rather than choice. In Ghana, for example, more than 60 percent of informal salaried and self-employed workers without employees would rather have formal wage jobs.<sup>8</sup> Informal mechanisms may be effective for small firms and simple transactions, but are insufficient for larger firms and complex relations with workers and markets. That may be why wage employment as a share of total employment increases as a country develops. Notwithstanding significant variation across and within regions, self-employment—a large part of which is likely of a subsistence nature—is widespread in the developing world (figure 5.1).

If the enterprise sector is to fulfill its role in supporting people's risk management, public policy for the sector requires reforms that balance the economy's need for flexibility with society's need for legal and regulatory protections. The chapter argues for a combination of reforms to help the enterprise sector become flexible as it gradually becomes formal. These reforms include improving the basic foundations of the enterprise sector by strengthening property rights and reducing uncertainty about government policy; implementing and enforcing sound regulations; and providing inclusive social protection. In the longer run, when sound regulations for flexibility are in place, the government can pursue reforms that encourage both flexibility and formality by spurring innovation; increasing the skill level of the labor force; and enhancing worker, consumer, and environmental protections. These reforms are necessary not only to increase growth but to enhance people's resilience and to promote prosperity. Although the risks that enterprises themselves face and their risk-taking decisions are very important aspects of a vibrant enterprise sector, this chapter maintains the Report's focus on risks faced by people. It thus focuses on the enterprise sector as a sector and on its function of supporting people and society in managing risk in different ways.

### **The ways that the enterprise sector can help people confront risks**

Let's step back for a moment and consider what the enterprise sector is. The enterprise sector comprises workers, owners, the arrangements that organize their relationships within an individual enterprise, and the technology that turns labor and capital into goods and services. Enterprises, the defining unit of the enterprise sector, range from informal to formal, from self-employment to partnerships to giant multinational corporations, and from agriculture

**FIGURE 5.1** Wage employment rises with the level of economic development

Source: WDR 2014 team based on data from World Bank World Development Indicators (database).

Note: Total employment consists of wage employment and self-employment. Organisation for Economic Co-operation and Development (OECD) countries in panel a are high-income countries that have been members of the OECD for at least 40 years. All other countries are grouped into geographic regions.

to manufacturing and services. Whereas a single enterprise might seek to maximize its profits, the enterprise sector as a whole is not confined to this objective. The sector encompasses the interests of workers, owners, and consumers, and—despite the possible important trade-offs between these interests—has the potential to help them manage risk through several channels discussed below. Flexibility and formality are important ways of ensuring that the enterprise sector can fulfill this function.

Enterprises include firms—enterprises in which two or more people work together. For workers and owners, being part of a firm widens the possibility of sharing the benefits and losses from specialization, collaboration, and innovation. Indeed, this is one of the main motives behind the formation of firms and, as such, has featured prominently in economic thinking at least since Adam Smith. Frank Knight and Ronald Coase, in their seminal studies, demonstrated the institutional advantage firms have in providing cost-efficient ways of dealing with uncertainty and overcoming the transaction costs inherent in direct exchanges.<sup>9</sup> Whereas most individuals

on their own are naturally risk averse and thus reluctant to take on new ventures, in groups and subject to contractual arrangements, they become more willing to pursue projects involving more risk but also promising higher returns. Firms can thus serve as natural vehicles to exploit opportunities, with beneficial consequences for individuals' resilience and prosperity.<sup>10</sup>

More specifically, the enterprise sector has the potential to support people's risk management through three channels: sharing risk; allocating resources and promoting innovation; and protecting workers, consumers, and the environment. This potential is not always realized, however. In reality, each of the channels can entail significant costs that are often borne by the most vulnerable. Every day, newspapers are filled with stories about enterprises—especially those with short-term horizons—that behave in ways harmful to workers, consumers, the environment, and even the enterprise sector itself. Government has a role to play in helping the enterprise sector achieve its potential to support people's risk management. In practice, however, governments that lack the capacity, the

appropriate incentives, and the correct strategy for public policy may undermine the flexibility and formality of the enterprise sector that can make these risk management channels effective.

### *Risk sharing*

The first channel through which the enterprise sector can support people's risk management is sharing risk among workers, among owners of firms and owners of capital more generally, and between workers and owners. Firms serve as a kind of risk pool that allows workers to share the workload, filling in for an absent coworker or helping out with unfamiliar or complex assignments. When a worker falls ill, for example, another worker can assume his or her tasks temporarily, reducing the risk of unemployment for the worker and helping to guarantee his or her income during the illness. More generally, the complementarities between skills of workers allows firms to respond to both positive and negative shocks more easily than individuals could on their own, thereby stabilizing and enhancing aggregate productivity and income growth. For this type of risk sharing, size is often an advantage. Smaller firms tend to be more volatile. A recent study found that in the United States, which has a highly developed and diversified enterprise sector, aggregate sales growth of the median small firm is five times more volatile than that of the big publicly traded ones.<sup>11</sup>

The enterprise sectors of many developing countries, however, are dominated by self-employment (see figure 5.1a); as a result, risk sharing among workers is limited. Rates of self-employment are around 70 percent in South Asia and exceed 80 percent in Sub-Saharan Africa, on average. This increases the vulnerability of the majority of workers in these regions to income shocks; a sick child, an equipment failure, or a change in the weather could mean the loss of a day's income. Such high rates of self-employment also suggest that the enterprise sectors in these regions are not benefiting from the specialization and increased productivity that multi-person firms make possible. As figure 5.1b indicates, a transition to wage employment is taking place in several developing countries, including Turkey, where the share of wage employment increased 50 percent between the early 1990s and the late 2000s.

The enterprise sector can also create opportunities for owners of firms—and owners of capital more generally—to share investment risk. When the owners of capital invest in firms that are exposed to different types and levels of risk, they are able to reduce the impact of a given negative shock on their investments through diversification, while still reaping the rewards of normal returns. An important legal risk-sharing mechanism for addressing capital risk is limited liability, which limits the losses for which a firm's owners are responsible and thus helps overcome individuals' natural risk aversion. Limited liability can encourage firms to take more creative risks, which in turn can increase productivity and facilitate the enterprise sector's provision of steady or increasing income and employment. The development of stock markets and the exploitation of economies of scale have arisen in large part as a result of limited liability. Risk sharing among firm owners can occur even without formal mechanisms.

In places where the business climate is unfriendly, informal networks and business groups often spring up to facilitate cooperation among firm owners in the face of changing commercial, economic, and political circumstances.

Labor arrangements also permit risk sharing between workers and firm owners. Workers can offer a form of insurance to firms, in which they agree to reductions in wages or cutbacks in hours and benefits during temporary shocks in exchange for higher wages in normal times. This type of risk sharing has been found, for example, in manufacturing firms in Cameroon, Ghana, Kenya, and Zimbabwe.<sup>12</sup> Alternatively, firm owners willing to take chances on new ventures and to accept greater profit variability can still offer steady wages to their workers, who are generally more concerned about the stability and predictability of their income. A similar dynamic applies when the source of variability is specific to the workers. For example, firms provide insurance to workers, in the form of a steady wage, for idiosyncratic risks such as illness.<sup>13</sup> Labor contracts can facilitate these arrangements by clearly defining responsibilities and enhancing enforceability.

In sum, firms can serve as vehicles for risk sharing, providing insurance for shocks to individual workers and for shocks in the production process, allowing workers to specialize, and enabling owners of capital to make more profitable investments.

**For risk sharing, achieving a certain size of firm is an advantage. While self-employment—so common in many developing countries—is a safety net, it is also a symptom of vulnerability.**

### *Resource reallocation and innovation*

Resource reallocation and innovation is the second channel through which the enterprise sector can support risk management. Resource reallocation occurs when enterprises shift resources, expand and contract, and enter and exit markets. Reallocation can take place across enterprises and industries, as less productive enterprises collapse and other more productive ones are launched. This is the process of creative destruction described vividly by Austrian economist Joseph Schumpeter. The enterprise sector is often faced with large external shocks that can be positive or negative, and can include large and sudden changes in supply and demand, increases and decreases in input prices, advances in or obsolescence of technology, and natural disasters. The sector can absorb these shocks, and reduce the damage they cause or take advantage of opportunities, by reallocating resources efficiently within and across enterprises and industries to more productive areas, while still providing the income, employment, and products that facilitate people's risk management. Without this process of resource reallocation, the enterprise sector would stagnate, become more volatile, and experience more prolonged recessions, with dire economic and social implications.

Making resource allocation in China and India as efficient as in the United States—provided that other factors such as institutional capacity were in place—could potentially increase total factor productivity by as much as 50 percent in China and 60 percent in India, recent research suggests.<sup>14</sup> In the United States, one of the world's most dynamic economies, creative destruction accounts for more than 50 percent of productivity growth.<sup>15</sup> Higher productivity can also translate into greater job security. For instance, in Romania, when the financial crisis hit in 2008–09, more productive firms were less inclined to fire workers.<sup>16</sup> So while job turnover can carry high costs of adjustment (which need to be addressed through inclusive social protection and other measures, as discussed later in this chapter), rigid rules prohibiting layoffs can also carry high costs.

The enterprise sector can also support risk management by allocating resources to the most productive enterprises and innovating to adjust to the world's ever-changing conditions. Innovation includes adoption and adaptation of new technologies and processes, especially by firms in the developing world. Resource reallocation and innovation are the essence of a process of experimentation and learning that can enhance productivity while improving

the capacity of the enterprise sector to respond to future shocks. Insufficient experimentation can sap the sector's ability to absorb such shocks. Innovation—investing in physical and knowledge-based assets—is at the heart of the ability of the enterprise sector to exploit the opportunities offered by new discoveries, particularly those opportunities that involve substantial risks.<sup>17</sup> Firms, which as entities can take on more risks than their owners and workers individually, are in a better position to promote the implementation of daring ideas that can lead to potentially productive ventures. Some ventures will fail—and should be allowed to do so. The success of the rest can provide both innovative processes for enterprises to absorb shocks better and innovative products for people to manage risk better. In the presence of risk sharing, risk taking and tolerance for failure on a broad scale can be the engine of growth and poverty alleviation for an entire country.

### *Worker, consumer, and environmental protection*

The enterprise sector has the potential to support risk management by facilitating the development and implementation of employment standards and production processes that protect workers, consumers, and the environment. Sound regulation and strong enforcement are crucial to bolster such protections. Firms that voluntarily adopt quality and environmental standards, such as those codified by the International Organization for Standardization (ISO), internalize costs of protection to their advantage, by improving their reputation or enhancing their productivity; at the same time, they can also contribute to worker, consumer, and environmental protection.

Worker health and workplace safety are key components of productivity. In the best scenario, enterprises that recognize this connection will strive to improve their work environment as part of their strategy to maximize profits. For example, a recent meta-analysis found that workplace wellness programs reduce medical costs by \$3.27 for every dollar spent on the program, and absenteeism costs by \$2.73; these are benefits that accrue to both workers and enterprises.<sup>18</sup> Because they can affect the bottom line, reputational concerns have the potential to shape how enterprises treat workplace health and safety standards.

Such considerations with respect to productivity and reputation can encourage enterprises to develop quality standards for consumer products (box 5.1). Standards designed to minimize defects and

### **BOX 5.1** *Worker, consumer, and environmental protection can also be profitable business*

The interests of firms and those of workers, consumers, and the environment are not always aligned. But when they are, significant benefits can arise.

Nestlé's entrance into the milk business in India is an example of how the global supply chain can improve local conditions for workers. To establish a well-functioning milk business in the Moga district of India, Nestlé had to work closely with local farmers, providing financing for wells, veterinarians for sick animals, and instruction in milk quality. This collaboration benefited Nestlé's milk business, which established a reliable supply chain. But the farmers of Moga benefited, as well. According to Michael Porter and Mark Kramer in their analysis in the *Harvard Business Review*, "Nestlé has been able to pay higher prices to farmers than those set by the government, and its steady biweekly payments have enabled farmers to obtain

credit." Nestlé has embarked on similar campaigns in Brazil, Thailand, and elsewhere.

While consumer and environmental protection often require public action, there are many examples of businesses launching initiatives to improve their production to benefit consumers and the environment. McDonald's Corp., for instance, has redesigned its packaging to allow consumers to access nutritional information using smartphones. Firms manufacturing bottled water, such as PepsiCo Inc. and Coca-Cola Co., have introduced bottle designs that use less plastic. Unilever, a consumer goods company, launched "Project Medusa" to increase the efficiency of the company's water usage by reusing water evaporated during cooking for equipment cleaning and for cooling.

Source: WDR 2014 team based on Porter and Kramer 2006.

increase product safety can raise consumer satisfaction and lead to higher profits. In recent years, many firms have begun to adopt a "quality philosophy" that extends from production to identification of consumer needs, to product design and assurance, to customer service.<sup>19</sup> Reputational effects can also discipline firms' treatment of the environment. At their best, social norms can discourage environmental mistreatment, civil society groups can watch for environmentally harmful production practices, and consumers can become informed about the environmental impact of the products they purchase.

At the same time, there are also many cases in which the enterprise sector undermines these protections or creates new risks for people, especially where institutions and regulations are weak. In some places, rapid economic growth has outpaced the development of workplace standards. Workers experience both hazardous workplaces and degraded environmental conditions created by those workplaces. For example, residents in the Madre de Dios department in Peru, a center of the informal mining highlighted in the beginning of the chapter, have significantly higher levels of mercury than other Peruvians, which is likely related both to the use of mercury in the mining process and to the consumption of fish from contaminated waters.<sup>20</sup> Child labor also remains a significant problem in many countries. More than half of all child laborers—some 115 million children—work in hazardous conditions, the International Labour Organization estimates. Even in more developed settings, there are cases where the safety and health of workers and consumers are

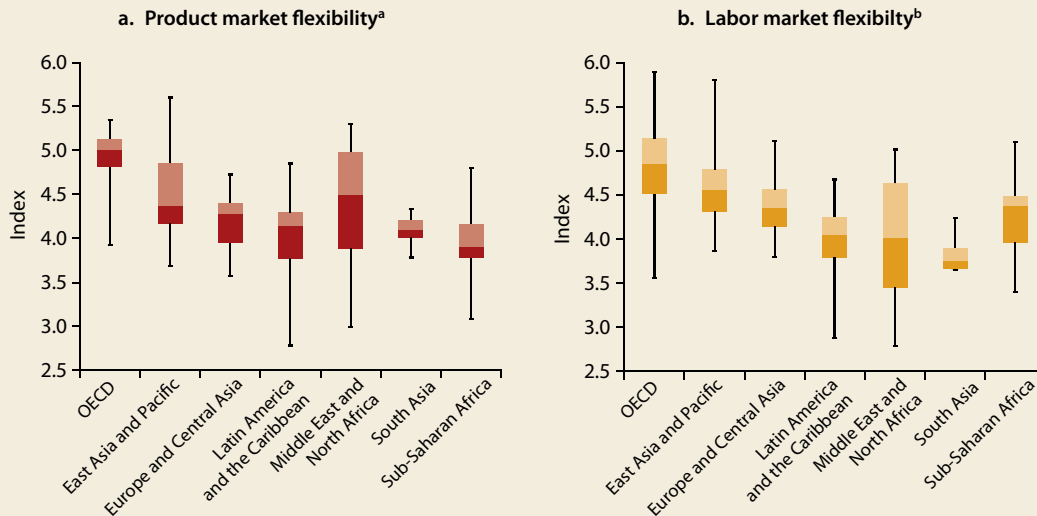
compromised. The government has a crucial role to play in designing and enforcing sensible regulations.

### **Flexibility and formality in the enterprise sector improve people's resilience and prosperity**

The shift to greater flexibility and formality can take time, and it requires complementary reforms to strengthen institutional capacity and improve regulations. When state institutions are weak and regulations are cumbersome, there are trade-offs between flexibility and formality. When state institutions are strong and regulations are sound, flexibility and formality can be symbiotic.

#### *The role and importance of flexibility*

Flexibility is the capacity to adapt to changing circumstances. The flexibility of the enterprise sector, and of individual enterprises, goes far beyond the narrow ability to hire and fire workers easily. Rather, it extends to the capacity to reallocate resources efficiently to more productive areas to respond to short-term shocks without seriously disrupting operations, and to increase capacity to respond to longer-term trends. Flexibility includes adjustments to risk-sharing arrangements among workers, among firm owners and owners of capital more generally, and between workers and firm owners. A flexible enterprise sector is one in which workers' skills are transferable, capital owners have abundant options for investment, and workers and firms

**FIGURE 5.2** *The flexibility of the enterprise sector varies around the world*

Source: WDR 2014 team based on data from World Economic Forum (WEF) 2012.

Note: The box plots show the minimum value, the range from the 25th percentile to the median (shaded dark), the range from the median to the 75th percentile (shaded light), and the maximum value for each region. The degree of flexibility rises with the numerical value, with 1 being the least and 7 being the most flexible. Organisation for Economic Co-operation and Development (OECD) countries in the figure are high-income countries that have been members of the OECD for at least 40 years. All other countries are grouped into geographic regions.

- a. Product market flexibility corresponds to the WEF's measure of goods market efficiency and consists of intensity of local competition, extent of market dominance, effectiveness of antimonopoly policy, extent and effect of taxation, total tax rate, number of procedures and time required to start a business, agricultural policy costs, prevalence of trade barriers, trade tariffs, prevalence of foreign ownership, business impact of rules on foreign direct investment, burden of customs procedures, imports as a percentage of GDP, degree of customer orientation, and buyer sophistication.
- b. Labor market flexibility corresponds to the WEF's measure of labor market efficiency and consists of cooperation in labor-employer relations, flexibility of wage determination, hiring and firing practices, redundancy costs, pay and productivity, reliance on professional management, brain drain, and female participation in the labor force.

are empowered to modify wages and employment levels potentially in their mutual interest. In a flexible enterprise sector, enterprises can expand and contract and enter and exit markets smoothly, and can innovate to capture new opportunities. Figure 5.2 shows two different measures of flexibility—one that corresponds to the efficiency of the market for goods (panel a) and the other to the efficiency of the market for labor (panel b). Both show that flexibility tends to be lower in the developing world.

Why is flexibility important? Flexibility enhances each of the three channels through which the enterprise sector supports people's risk management. Flexibility facilitates the risk sharing that allows workers and firm owners to respond to shocks, while providing opportunities for steady income and employment at the aggregate level. Complementary skills and specialization can help firms, especially larger ones, take advantage of increases in demand or the introduction of a new technology. In contrast, when labor arrangements between workers and own-

ers are rigid, even small, idiosyncratic shocks can be very costly and threaten a firm's survival. Finally, the broader the opportunities in which firm owners can invest, the more diversified the risk they will bear. A shallow capital market or one with high transaction costs can cause investors to forgo good investment opportunities.

An enterprise sector that generates income opportunities even during times of economic difficulty is particularly vital in countries with weak social protection systems. In these countries, people without a job cannot rely on public help and must find some source of income. Where the costs of formality are high, this income very often comes from informal work—recent research shows that in the majority of countries, informality functions as a safety net for those who are not part of the formal economy.<sup>21</sup> The informal sector often provides the flexibility that people need for survival.

A flexible enterprise sector supports the reallocation of resources within enterprises and across



enterprises and industries. Flexibility means that in response to shocks, the sector can efficiently redeploy labor and capital to more productive enterprises and more productive industries, potentially in the mutual interests of workers and firm owners. As the *World Development Report 2013: Jobs* indicated, jobs are drivers of development, and all types of employment, including informal jobs, can be transformational in improving living standards, productivity, and social cohesion.<sup>22</sup> The ease of dismantling collapsed businesses and of creating new ones is crucial to ensuring that new employment opportunities are created. Adjustment costs during this reallocation process can be significant, however, particularly for newly unemployed workers. Inclusive social protection systems need to be in place to protect the vulnerable.

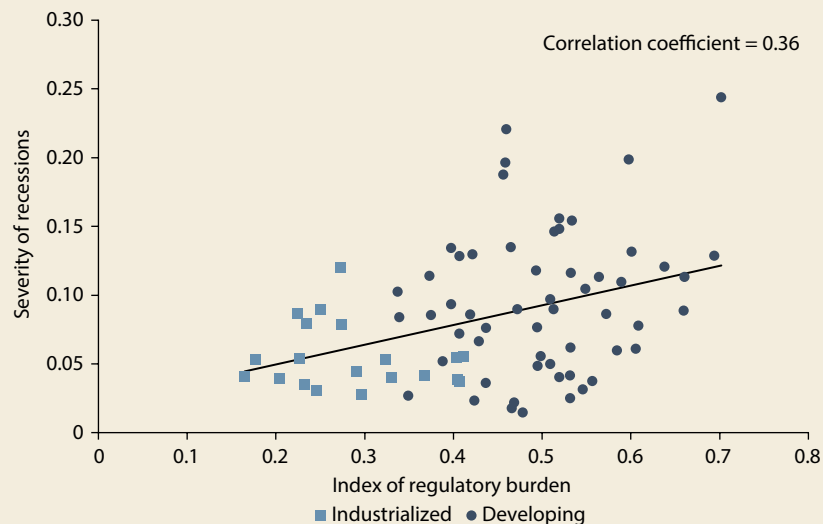
Research on recovery from negative shocks demonstrates the harmful effects that rigidity can have. Using empirical evidence from 76 countries, a recent study found that economies with policy-induced rigidities such as excessive labor protections, barriers to firm entry, burdensome bankruptcy laws, and industry supports suffer deeper and more prolonged recessions (figure 5.3) than more flexible economies do. The study substantiated this evidence by mod-

eling the recovery of an undistorted (flexible) economy and the recovery of an economy in which the government intervenes with subsidy after a shock. The results are striking. The flexible economy suffered a loss of 13 percent of preshock gross domestic product (GDP)—84 percent of which occurred in a single quarter—whereas the economy in which the government intervenes suffered a loss of 36 percent of preshock GDP spread out over five years. A smaller, faster loss implies a quicker recovery.

An examination of recent great depressions corroborates this evidence (box 5.2), as does cross-country research: impediments to resource reallocation to more productive firms reduce the pace of economic recovery. For example, by propping up banks and requiring them to maintain nonperforming loans to firms that otherwise would have failed in the late 1990s and early 2000s, Japan prevented their resources from flowing to more productive uses.<sup>23</sup> Better regulation, in contrast, can promote the reallocation of resources to more productive firms.<sup>24</sup>

Factors other than governmental regulation also can impede flexibility. One example is gender segregation in employment, which often hampers labor market flexibility; this issue is discussed extensively in

**FIGURE 5.3** *Countries with a higher regulatory burden experience more severe recessions*



Source: WDR 2014 team based on data from Bergoing, Loayza, and Repetto 2004.

Note: Index of regulatory burden varies from 0 to 1, where 1 indicates the heaviest burden. Data on regulatory burden cover financial restrictions, trade barriers, firm entry costs, inefficient bankruptcy procedures, bureaucratic red tape, tax burden, and labor regulations for the 1990s. The severity of recessions is measured by the sum of downward output deviations from trend for each country during 1990–2000. The solid (regression) line in the figure depicts the fitted linear relationship between the y- and x-axis variables, allowing for an intercept.

### BOX 5.2 *Lessons from great depressions*

How should public policy respond to unusually large declines in output? While the benefits and limitations of expansionary monetary and fiscal policy in such cases have been examined and debated extensively, enterprise policy may play an especially important role, according to comprehensive analysis of the historical evidence by Timothy Kehoe and Edward Prescott in their exhaustive work, *Great Depressions of the Twentieth Century*.

In contrast to the relatively shallow and brief recessions that are typical of business cycles, “great depressions” are unusually deep, painful, and long.<sup>a</sup> The Great Depression of 1929–39 in the United States is perhaps the best-known example, but several European countries had similar experiences in the period between the first and second world wars, and some recent examples have occurred in Latin America, New Zealand, and Switzerland.

Such experiences have often been treated by economists as exceptions to which standard macroeconomic models may not apply. Instead, Kehoe and Prescott seek to use the modern tools of macroeconomics (specifically, growth accounting and the general equilibrium growth model) to scrutinize the underlying drivers of depressions in more than a dozen countries. Their findings suggest that the level of productivity growth is often the dominant driver of depression dynamics, while changes to labor input are also important in some cases.

What policies dampen productivity growth during depressions? First, not letting inefficient firms fail is crucial. For example, Chile

and Mexico both experienced depressions in the early 1980s, but productivity growth recovered, and even exceeded trend, in Chile, while it remained 30 percent below trend in Mexico nearly 15 years later. Banking and bankruptcy procedures appear to have been central to the different outcomes. By the early 1980s, unproductive firms in Chile were allowed to go bankrupt, with new investments determined by market interest rates, whereas the state-controlled banking system in Mexico continued to channel loans to some unproductive firms through the early 1990s. Second, studies of the manufacturing, construction, and mining industries suggest competition policy may be important, insofar as more competitive industries tend to be more creative and productive in the aftermath of a large output decline.<sup>b</sup> Finally, tax increases and rigid wage policies have been shown to reduce labor input during great depressions. For example, rigid real wage policies appear to have been a key factor in prolonging the great depression of 1928–37 in Germany. In contrast, flexible labor regulations helped Germany escape the worst of the recent crisis (see box 5.5).

Recent microeconomic evidence finds that, besides the types and productivity of the technology used within individual firms, resource allocation across firms is a crucial determinant of cross-country differences in productivity.<sup>c</sup> The emerging literature in this field supports the view that facilitating resource reallocation can be an essential part of bringing depressions to an end.

Source: WDR 2014 team based on Kehoe and Prescott 2007.

a. Kehoe and Prescott 2007 define great depressions as declines in output per capita of at least 20 percent below trend, with at least 15 percent of the decline occurring within the first decade of the depression, and annual per capita output growth remaining below trend for each year of the depression.

b. Baily and Solow 2001.

c. See Restuccia and Rogerson 2013 for a useful review of the recent literature.

*World Development Report 2012: Gender Equality and Development*.<sup>25</sup> In most countries, women are more likely than men to participate in low-productivity activities, in the informal sector, and in family employment. Another factor involves exclusive business relationships. In Sub-Saharan Africa, for example, relationships formed through business activities can exclude unconnected communities from more profitable investment opportunities and perpetuate existing patterns of production.<sup>26</sup>

Innovation and flexibility are closely linked. The more easily resources flow to entrepreneurs and firms that offer new products, better technologies, and more efficient processes, the more quickly the enterprise sector can generate new opportunities at lower costs. Nonetheless, innovation can have adverse consequences for employment: for example, process improvements may allow an enterprise to produce the same output with less labor, leading to cutbacks or unemployment. Even innovation that results in positive (or zero) job creation might have a “skill bias”

against unskilled labor.<sup>27</sup> That said, these negative effects can be counterbalanced when cost reductions associated with innovation spur price reductions, which in turn stimulate growth in aggregate terms, leading to greater demand and output over time. Product innovation, in contrast to process innovation, tends to stimulate domestic and foreign demand and so enhance an enterprise’s demand for labor.

Flexibility is also closely related to worker, consumer, and environmental protection. In Bulgaria, for example, a firm’s capacity to change—based on measures such as leadership, trust, innovation, and accountability—was found to be strongly positively associated with environmental performance.<sup>28</sup> Without flexibility, an enterprise will be unable to adjust its products or production techniques in response to the displeasure of consumers and civil society or to take appropriate action in the case of a defective, environmentally harmful, or dangerous product.

Although corporate responses to complaints about product and worker safety are often (rightly)

criticized for being insufficient or ineffective, enterprises do seem to be able to adjust to and, at least at times, remedy such deficiencies. One famous case involved the Johnson & Johnson painkiller Tylenol, whose market share plummeted from 37 percent to 7 percent after several bottles were found to have been contaminated with cyanide. The firm removed all Tylenol from the market and adopted and advertised a “triple safety seal.” In less than two years, the company had nearly regained its previous market share.<sup>29</sup> The incident led the U.S. Food and Drug Administration to issue regulations regarding drug packaging, and safety shields became the norm in the industry. Many enterprises operating in developing countries have also responded to concerns about product and worker safety, although these measures have had only limited success.<sup>30</sup>

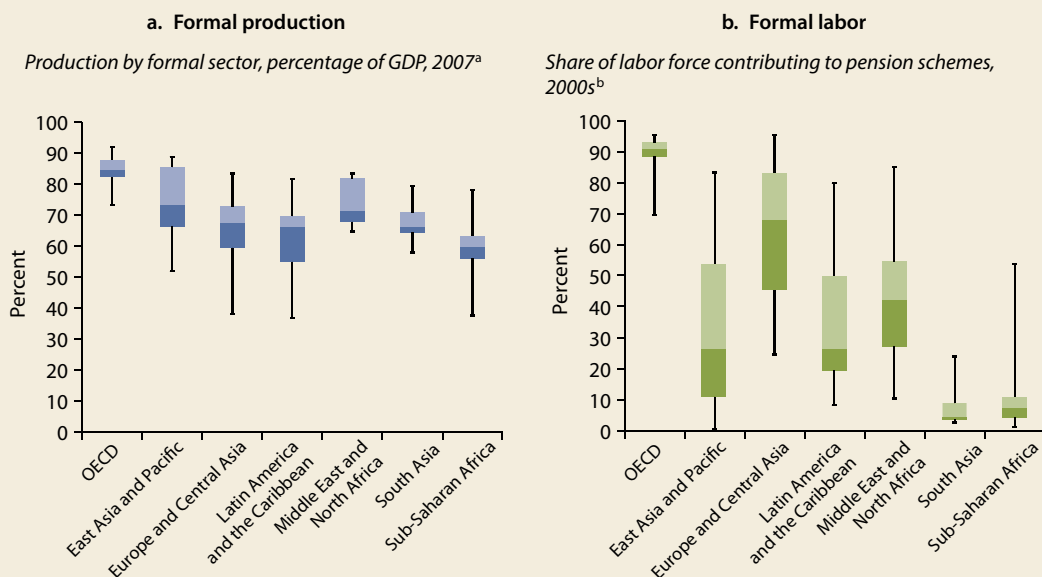
### The role and importance of formality

Enterprises are considered formal if their activities comply with laws and regulations governing taxes, registration, labor and workplace standards, product

quality and safety requirements, and environmental guidelines—all of which can be costly to implement. In exchange, formal enterprises are entitled to enhanced access to legal protection and public infrastructure. Formality and informality, however, are a matter of degree. Some enterprises are in compliance in some but not all dimensions of formality. For example, some enterprises that comply with registration procedures may substantially underreport their sales and profits or only partially fulfill requirements to provide benefits and workplace protection to workers. Moreover, there is a wide gap between *de jure* formality and *de facto* formality, particularly in countries with weak institutional capacity.

Formality varies widely across countries (figure 5.4). The large differences in labor and production formality across countries and regions suggest the existence of a massive labor pool yet to be mobilized in formal—and likely more productive—activities. That is especially likely to be the case in countries with relatively high production formality but low labor formality. Informality is not a cause, but rather a symptom, of underdevelopment. In general, formal

**FIGURE 5.4** *The formality of the enterprise sector varies around the world*



Source: WDR 2014 team based on data from Schneider, Buehn, and Montenegro 2010 (panel a); World Bank Pensions (database) and World Bank World Development Indicators (database) (panel b).

Note: The box plots show the minimum value, the range from the 25th percentile to the median (shaded dark), the range from the median to the 75th percentile (shaded light), and the maximum value for each region. Organisation for Economic Co-operation and Development (OECD) countries in the figure are high-income countries that have been members of the OECD for at least 40 years. All other countries are grouped into geographic regions.

- a. Values computed as 100 minus estimates on the size of shadow economies by Schneider, Buehn, and Montenegro 2010.
- b. Figure based on the latest data available in the 2000s.

employment tends to increase with the level of development. By helping to ensure that wages are paid and contracts honored, that property will not be seized, and that financial resources are available and affordable, formality helps both workers and enterprises to plan for the future. Compliance with labor, consumer, and environmental protections—while costly—can also lay the basis for growth, as discussed throughout this chapter.

Why is formality important? Like flexibility, formality enhances each of the three channels through which the enterprise sector supports people's risk management. Formal firms tend to be bigger, more stable, and better able to provide steady work for their employees. Because formal firms have a more predictable environment in which to grow and hire more employees, workers are better able to share the risk. Capital owners can invest in formal firms to diversify their own risk and jump-start growth for the business, thanks to the legality of contractual arrangements. Finally, formality means that contracts between workers and firms are more easily enforced and so less likely to be broken. Even in the absence of contracts, formality can provide both workers and employers with legal recourse if a labor arrangement is perceived to have been broken, reducing the risk to both parties of noncompliance. Small firms may be able to rely on informal institutions to enforce contracts. Such informal mechanisms become less effective, however, as firms grow and the relationships between owners and workers become more complex.

The stronger risk-sharing arrangements promoted by formality improve people's level and stability of income, one of the most significant factors in improving risk management. For example, average monthly earnings in Zambia generally increase with formality. In Tanzania, income volatility generally decreases with formality. Only 9 percent of informal employees in francophone West Africa had a written contract with their employers.<sup>31</sup>

Lack of formality can inhibit risk sharing across firms, as well. In Zimbabwe, for instance, the risk that suppliers will not comply with contracts has led manufacturing firms to increase inventories and liquidity reserves to protect against late delivery, non-payment, or late payment.<sup>32</sup> This imbalanced type of risk sharing is unlikely to be efficient in a world in which just-in-time delivery is becoming the norm.

The laws and regulations that accompany formality can expedite the process of reallocating resources. Well-designed and consistently applied procedures are essential for resources to flow efficiently out of collapsed enterprises and toward new ones. Bankruptcy law and the depth of resale markets are par-

ticularly important to liberate productive resources from an unproductive enterprise and to ensure that creditors, and potential investors in other enterprises, are protected if a business fails. Laws that protect the intellectual property of established enterprises and entrepreneurs alike are often an important incentive for innovation. Finally, formality provides the legal documents that are frequently necessary to access credit and other financial resources. Such access supports business expansion, promotes new enterprises, and can provide a lifeline to enterprises in the face of shocks. Overall, cross-country analysis suggests that an increase of one standard deviation in informality leads to a decline of 0.7 to 1.0 percentage point in the rate of per capita GDP growth.<sup>33</sup> Further, countries with high informality cannot fully capture the benefits of globalization (box 5.3).

Formality may strengthen an enterprise's incentives to provide worker, consumer, and environmental protection. Good regulation can induce enterprises to internalize the social costs of their activities. That is particularly clear in the case of environmental rules that force firms to absorb some or all of the costs of polluting. It is also true of workplace protections that prohibit firms from paying very low wages when the supply of labor is abundant. Governmental regulation can thus create a level playing field for firms to compete by increasing worker productivity and consumer satisfaction through provision of a healthy workplace and environmental stewardship, rather than by paying poor wages, providing poor working conditions, or cutting costs at the expense of the environment. The legal identity provided by formality strengthens a firm's incentive to cultivate a reputation consistent with a healthy workplace, product quality, and environmental protection.

Employee access to benefits and safe workplaces tends to improve with formality. In Mozambique, the share of paid employees with a range of employment benefits, such as remunerated sick leave and severance payments, generally increases with the formality of employment, as does the share of workers in Zambia who use protective clothing when working.<sup>34</sup>

At the same time, formality is not a sufficient condition for worker, consumer, and environmental protections. These protections can be weak or absent even when firms are large multinationals or linked in a global value chain. In fact, the growth of global value chains has a dual effect, putting pressure on enterprises to comply with more stringent labor and production standards while increasing pressure to reduce labor costs, even by resorting to informal work. This situation results in improved employment for some workers, but informality and instabil-

### BOX 5.3 *The complex relationship between globalization and formality*

Globalization brings new opportunities and risks. As many as 20 million people are directly employed in the manufacturing sector for global value chains. A large proportion of these are women and rural migrants in poor countries.<sup>a</sup>

In Costa Rica, investment from Intel has translated into accelerated formation of technical and English skills for workers. Standards of practice from the U.S. market, especially regarding worker and environmental protection, were actively transferred to the local economy, with Intel requiring its suppliers and subcontractors to meet strict worker safety qualifications and sending its employees to promote recycling programs and environmental awareness. Following Intel's socioeconomic contributions, the National Insurance Institute, Costa Rica's autonomous insurance institution, has created the nation's first job safety and health standard.<sup>b</sup>

In Mexico, the influx of export manufacturing jobs from 1985 to 2000 increased female formal employment nearly fivefold. These jobs offered higher wages than agriculture and other alternatives. The higher earnings increased the bargaining power of these women within their households and led to observable improvement in child health: the children of women who worked in formal export manufacturing were more than one standard deviation taller than the children whose mothers did not have their first job in manufacturing, and this effect was stronger for girls.<sup>c</sup> In Indonesia, during the East Asian crisis in the late 1990s, the aggregate adverse effect on employment was smaller for female workers because they were concentrated in larger firms and firms that exported, which were less hard hit.<sup>d</sup> On the other hand, the influx of relatively low-skill jobs also induced high school students to drop out of school; for every 20 new jobs created, one student left school in Mexico.<sup>e</sup> More recently, the trade collapse

after the global crisis resulted in large layoffs in the *maquiladora* and in related industries.

Benefits from globalization accrue more to the formal economy because informal enterprises often do not have the appropriate standards and qualifications from the suppliers' standpoint to compete. Economies with high rates of informality are thus often positioned at the lower end of the global value chain, and their workers are more vulnerable to global shocks and less likely to benefit from opportunities. Recent research suggests that globalization has contributed to the prosperity of many countries, although sometimes at the cost of rising inequality.<sup>f</sup>

In the long run, economies that are more open tend to have a lower incidence of informal employment. In several countries in Asia, an increase in a country's openness has been associated with a reduction in the incidence of its informal employment. In Mexico, reductions in tariffs after joining the North American Free Trade Agreement significantly reduced the likelihood of informality in the tradable sectors.<sup>g</sup> In the short run, however, the impact of globalization on informality may be mixed, depending on the nature of the globalization process and the various economic fundamentals of the economy. For example, an overly rapid trade liberalization can wipe out the protected formal sectors and push their workers into self-employment or informal sectors. Given the high informality in many developing countries, particularly in agriculture, retail, and other services, the benefits of globalization may not reach many segments of the population, while shocks from the global arena can negatively impact their lives. Overall, globalization exposes enterprises to competition in the world market, providing incentives for productive enterprises to expand and pressures for unproductive ones to exit.

Source: WDR 2014 team.

a. UNCTAD 2013.

b. World Bank 2006.

c. Atkin 2009.

d. Hallward-Driemeier, Rijkers, and Waxman 2011.

e. Atkin 2012.

f. Kremer and Maskin 2006.

g. Aleman-Castilla 2006.

ity for others. A case study of garment factories in Morocco, for example, found that some high-skilled workers involved with the final product and with oversight of packaging, storage, and logistics for buyers had stable contracts and protections. However, factories also hired irregular workers to meet buyers' demands. These workers had casual contracts and were often subjected to discrimination.<sup>35</sup> In addition, because global value chains are not always linked to local value chains, the safety and quality benefits from industry standards that are enjoyed by global consumers may bypass domestic consumers.<sup>36</sup>

Furthermore, formality is not a guarantee against negligent or criminal acts. For instance, in 2012,

more than 250 workers died in a fire at a garment factory in Pakistan that had been certified as meeting international health and safety standards.<sup>37</sup> Industrial disasters such as the Bhopal gas leak in 1984 and, more recently, the Deepwater Horizon oil spill in the Gulf of Mexico and the Fukushima Daiichi nuclear disaster in Japan continue to put people and the environment at risk.

### *The relationship between flexibility and formality*

Burdensome laws and regulations can raise the costs of formality. Complicated and lengthy business ap-

plication processes, onerous taxes, stringent hiring and firing rules, poor-quality public services such as police and courts, and a lack of educated workers can discourage informal enterprises from becoming formal. In these cases, there is a trade-off between flexibility and formality: to maintain flexibility, enterprises remain informal. While remaining informal may be optimal for individual enterprises, the enterprise sector as a whole suffers, because the advantages of formality are sacrificed. The seminal work of Hernando De Soto quantified the costs of formality and the extent to which excessive regulation can lead to abuses and foster informal activities.<sup>38</sup> As the cost of formality declines, the trade-off between flexibility and formality also declines.

When laws and regulations are focused, well-designed, and consistently applied, the costs of complying with them are low relative to their benefits. In this case, formality and flexibility reinforce each other. As the economy moves from high-cost formality to low-cost formality, trade-offs decline and flexibility and formality become symbiotic. Formality helps enterprises adapt to changing circumstances, with laws and regulations that make it easier to renegotiate labor arrangements, reallocate resources, and encourage innovation, and that level the competitive playing field. Flexibility, in turn, makes it easier for enterprises to comply with laws and regulations while remaining productive.

Flexibility is a reasonable short-term goal. Formality is a longer-term objective. In the short term, helping enterprises adjust to the world's ever-changing circumstances is critical, even without formality. In many low-income countries, especially in Sub-Saharan Africa and South Asia, even if economic growth rates are high, the formal sector cannot generate enough wage employment in the near future to absorb the majority of the labor force. The informal sector remains the main contributor to GDP and to employment. Self-employment and household enterprises serve as important means of survival for the most vulnerable. An empirical study covering eight countries in Africa, for example, found that household enterprises were responsible for the creation of most new nonagricultural jobs.<sup>39</sup> Increasing the flexibility of the enterprise sector to create more, and more-productive, jobs—both formal and informal—is crucial in helping people manage risk and reduce poverty.

In the longer run, however, formality strengthens the contribution of the enterprise sector to making people resilient to shocks. Increasingly, formality is becoming a necessary condition for joining the

global supply chain. The quality and performance requirements (including standards and certifications) for global exports are too strict to be met by the informal economy on the supply side. When international competitive pressures intensify, the informal economy can actually be pushed out of the global value chain. As economists Rafael La Porta and Andrei Shleifer put it recently, “Informal firms keep millions of people alive but disappear as the economy develops.”<sup>40</sup>

The transition to flexibility and formality is not easy. There is no single recipe for success; the transition depends on the specific country context, including factor endowment, history, and culture. In Malaysia, reforms in business and labor market regulations contributed to a more flexible economy.<sup>41</sup> In Costa Rica, relatively high education levels and fiscal incentives attracted large inflows of foreign direct investment that, together with advanced technology and product standards, helped create more formal jobs and reinforce skills building. With the right steps, pace, and sequence, countries can become flexible and formal in the longer run (figure 5.5).

### How can the government help enhance the flexibility and formality of the enterprise sector?

In the transition to formality and flexibility, the quality and enforcement of policy and regulation are essential. The government can play a key role in lowering the costs and increasing the benefits of formality and flexibility. The government's focus should be on improving the attractiveness of formality; penalizing informality would damage the safety net that informal enterprises can provide when the state is weak or formality is prohibitively costly. The government should also focus on reforming complementary areas at the same time. If policy reforms are to have the desired effect, they must also be tailored to specific country conditions, such as institutional capacity, political environment, and the stage of development of the labor market.

The government can help in four main ways. It can lay the basic groundwork for enterprises to operate by strengthening property rights and reducing uncertainty about government policy. It can implement and enforce sound regulation. It can put in place inclusive social protection to protect workers, particularly the vulnerable. Finally, over time, it can strengthen policies that improve both flexibility and formality in the longer run.

**FIGURE 5.5** *Typology of countries by the flexibility and formality of their product and labor markets*

Source: WDR 2014 team based on data from World Bank Pensions (database); World Bank World Development Indicators (database); World Economic Forum 2012; and Schneider, Buehn, and Montenegro 2010.

Note: Economies in the top row are high (above the median value) in both product market flexibility and labor market flexibility (figure 5.2); in the middle row they are high in one or the other of the two; and in the bottom row they are low (below the median value) in both flexibility indicators. Similarly, economies in the first column on the left are low in both formal production and formal labor (figure 5.4); in the middle column they are high in one of the two formality indicators; and in the last column on the right they are high in both formality indicators. Only economies with data for all four indicators are considered, and median values are calculated within this sample.

Several of the policies discussed in this section are frequently associated with productivity and growth policy. This is no accident. A better investment climate can improve risk management in the enterprise sector: improving respect for rules and regulations and increasing flexibility can help the sector respond to negative shocks and take advantage of opportunities. The more capable the enterprise sector is of managing risk, the more productive it can become. A government that supports the rule of law and transparent contracts and that does not act capriciously toward local and international investors can be the cornerstone for a vibrant enterprise sector (see box 5.4).

### *Lay the groundwork for a vibrant enterprise sector*

Some policies, such as securing property rights and reducing uncertainty about government policy, are foundational in the sense that they lay the basic groundwork for the enterprise sector to operate. In fragile and conflict-afflicted states, strengthening national institutions and improving governance to provide citizen security, justice, and jobs are crucial first steps to break cycles of violence.<sup>42</sup>

*Secure property rights.* Secure property rights are essential to assure investors that their risk taking

**BOX 5.4** *The resilience of the power sector during a period of civil unrest in Côte d'Ivoire was driven by protections for contracts*

Côte d'Ivoire is one of the countries in Sub-Saharan Africa that has pioneered private sector participation in the power sector. Since 1990, a private operator (Compagnie Ivoirienne de l'Electricité, or CIE) has managed the country's power sector. As of 2006, independent power producers (IPPs) accounted for nearly two-thirds of energy production. Severe droughts, a significant currency devaluation immediately before the IPPs were set up, civil war, and the suspension of a large part of revenue from power sales for an extended period of time have all affected the sector's performance. Rather than buckle under the combined pressures of these events, the sector has largely thrived, in part because of a combination of flexibility and formality among sector participants.

The two main IPPs, Compagnie Ivoirienne de Production de l'Electricité (CIPREL) and Azito Energie SA (Azito), continued to deliver electricity throughout the period of civil unrest; at times, employees guarded the plants around the clock—an act of resilience of which both owners and staff remain justifiably proud. Perhaps even more impressive has been the companies' decision to continue to supply power even when the government could not meet the terms of its contracts. The contracts require the companies to provide a certain amount of power each year, according to

a fixed price or schedule of prices. Two major civil conflicts in the past decade significantly affected revenues and collection. Political fragility at the national level also made tariff adjustments next to impossible. From late 2010, at the peak of the most recent crisis, arrears to the IPPs built up, but rather than exercise penalty clauses under the contracts or shut down production, the two IPPs instead exercised forbearance, recognizing both the underlying robustness of the contracts and the central role played by their companies in the economy. The enterprises understood that the payment arrears had arisen from a temporary shortage of funds, rather than any intention on the part of the government to default. Indeed, the government signaled its good faith by paying all the parties in fixed proportions, according to its ability to pay. Ultimately, the IPPs understood that the sanctity of the contracts would be honored. With the consolidation in political power under a new government, this belief has been validated and the arrears have now been repaid.

Since the recent stabilization, both CIPREL and Azito have announced plans to expand their operations, which will increase investment and the energy supply and support economic growth and political stability in the postconflict state.

Source: Conor Healy for the WDR 2014.

will yield rewards. Government nationalization and expropriation of private sector assets undermine incentives to invest in a country. Countries with sound investor protections tend to grow faster than those with poor investor protections; countries with weak enforcement of contracts are characterized by greater macroeconomic volatility; and countries with reliable law and order have smaller informal enterprise sectors.<sup>43</sup>

*Reduce uncertainty about government policy.* A stable policy environment and certainty about regulation is a key determinant of domestic as well as foreign investment (see chapter 7). In Thailand in the mid-2000s, for instance, political instability was perceived as a major constraint on doing business, contributing to a decline in business sentiment and in private investment growth, despite improvement in several other aspects of the business environment.<sup>44</sup> When investors are uncertain about the future, they may demand higher rates of return to compensate them for the extra risk involved. They may also shorten their planning horizons, thus influencing their level and form of investment, choice of technology, and willingness to train workers. Policy uncertainty can have dire consequences for private investments, par-

ticularly those in infrastructure and other decisions that involve large sunk costs. Uncertainty increases the value to investors of waiting and can lead to significant declines in hiring, investment, and output.<sup>45</sup> Improving the predictability in the way the rule of law is applied and the credibility of reforms is crucial for private sector development. In Côte d'Ivoire, for example, the power sector thrived, even in a fragile environment, thanks in part to the private operator's trust in contract durability (box 5.4).

### *Implement sound regulations*

Reform of burdensome and costly regulations that reduce enterprise sector flexibility and discourage the operation of formal enterprises should be a priority. Flexibility does not mean the absence of regulations; rather, sound regulations are needed to improve the business environment and mitigate risks for enterprises and their owners and workers.

*Improve the regulations that affect the enterprise sector.* Weak or obstructive regulations can needlessly hinder the development of the enterprise sector and impede competition. Worldwide, some 23 percent of registered firms consider tax administration to be a



major or very severe obstacle, for example.<sup>46</sup> More broadly, research suggests that countries that move from the worst quartile of business regulations to the best could enjoy a 2.3 percentage point increase in annual growth.<sup>47</sup> Several important aspects of regulations identified in the *Doing Business* reports, such as starting a business, paying taxes, and resolving insolvencies, are generally more cumbersome in low-income countries than in middle- and high-income countries.<sup>48</sup>

*Streamline business registration.* An enterprise that demonstrates compliance with the appropriate rules and regulations should not have to wait for years to receive a permit to operate. Many countries have successfully increased the efficiency of registration by establishing online procedures and linking the relevant agencies with a single interface. Cross-country research suggests that reducing the cost of registration procedures to the level in the United States could increase the number of new firms by more than 20 percent.<sup>49</sup> In India after licensing reforms, innovation in the formal manufacturing sector increased by roughly 5 percentage points.<sup>50</sup> Reducing the cost and time of registration processes alone is not always enough to promote business formalization, however. In Brazil, where obtaining a business license has been eased but still remains complicated and where the tax burden associated with the registration is high, most informal firms choose to stay informal.<sup>51</sup>

*Reduce rigidities in labor market regulation.* Reforming a single policy, such as labor market regulations, on its own will probably not have a large impact. Yet when labor market regulations are too rigid, they can undermine the resilience of the economy (see spotlight 5). An empirical study covering some 60 countries finds that moving from the 20th to the 80th percentile in regulatory labor rigidity reduces the speed of adjustment to shocks by one-third and lowers annual productivity growth by as much as 1.7 percent.<sup>52</sup> Evidence from 20 European countries shows that in countries with high firing costs, firms are more likely to hire temporary workers as their employment needs grow.<sup>53</sup> In Nicaragua, a 10 percent increase in the minimum wage from 1998 to 2006 raised wages by 5 percent for workers whose wages were within 20 percent of the minimum wage but also reduced re-

lated private sector employment by 5 percent. Those who lost their jobs generally did not find new ones and left the formal labor force.<sup>54</sup> Rigid labor market regulations that reduce incentives for firms to offer more stable jobs with enforceable contracts might disproportionately hurt the most vulnerable, such as women and young workers. In Indonesia, for example, the minimum wage is more binding for small firms and results in disproportionate job loss for female workers.<sup>55</sup>

*Improve measures for resolving insolvency.* Long and expensive bankruptcy procedures clutter the market with failed firms that block opportunities for new enterprises. Enhanced predictability and improved bankruptcy procedures can help facilitate responsible risk taking and reduce associated costs. Effective bankruptcy can help avoid many distortions—including, in some cases, taxpayer commitments in the form of bailouts.<sup>56</sup> The government can streamline corporate bankruptcy and encourage rapid reuse of assets to reduce the time and cost of bankruptcy and increase recovery of losses for creditors and investors. Reorganization may be an option for firms with proven viability that are in temporary financial distress. The challenges for the state are to balance the protection of failed entrepreneurs' rights with that of creditor rights and to limit the moral hazard for entrepreneurs to act imprudently.

**A better business environment is good not only for productivity growth but also for resilience in the face of adverse shocks.**

*Improve enforcement of regulations.* Improving regulatory certainty also requires strengthening the implementation and enforcement of laws. For example, when countries such as Azerbaijan and the Kyrgyz Republic were initially moving up in the World Bank's *Doing Business* rankings, the local private sector reported that the business environment had not improved much because the reforms were not fully implemented. Investor Motivation Surveys show a correlation between the amount of discretion allowed in applying regulations and variance in delays in compliance. Overall, governments with less discretion in applying regulations present lower investment risk. That is particularly the case where institutional capacity is weak and effective safeguards against corruption are not in place. Governments can start to address the problem by drafting laws and regulations with as much clarity as possible to limit discretion in interpretation. To reduce the incidence

of discriminatory implementation, the government can strengthen its accountability system, both by increasing the transparency of regulations and by improving feedback mechanisms to ensure fair and timely treatment of all entrepreneurs.<sup>57</sup>

### *Provide inclusive social protection and insurance*

Policies to improve labor market flexibility and provide social protection need to be pursued in parallel. Increased flexibility improves efficiency by reallocating resources between and within firms, but can be costly for those who lose their jobs. To protect the vulnerable, including those in employment transitions, the government needs to put in place a system to provide voice and inclusive social protection. In turn, an inclusive system that covers basic health and education needs and targets the vulnerable may also promote a more dynamic enterprise sector (see chapter 3).

*Build an inclusive social protection system.* Flexible labor market policies can increase aggregate employ-

ment, as an empirical study with panel data from 97 countries reports.<sup>58</sup> Yet flexibility can lead to increased job turnover, which can increase the risk of unemployment and income loss for workers in transition. Promoting flexibility need not mean that workers who lose their jobs are completely at peril of prolonged unemployment, however. Germany and Denmark provide interesting but diverse examples of policies that combine labor market flexibility with social support. In their specific contexts, the German model highlights the potential to maintain stable employment through internal flexibility—in particular through adjustments to working hours and work-sharing—while the Danish “flexicurity” model is characterized by easy hiring and firing alongside a strong safety net and reemployment policies (box 5.5).

*Provide support for training and retraining, especially for the vulnerable.* Public support for training works best when enterprises and workers themselves have an incentive to invest in skills. To the extent that lack of resources is an obstacle to training, however, the

### **BOX 5.5** *Labor market flexibility alongside social support: Examples from Germany and Denmark*

As mentioned at the beginning of the chapter, during the most recent global recession, Germany has offered one model of how to combine labor market flexibility and stable employment. Labor market reforms enacted in the first half of the 2000s provided incentives for older workers to return to work, supported job search efforts, and implemented stricter monitoring of eligibility for unemployment benefits. In response, the share of permanent full-time jobs declined, while the share of flexible or nonstandard jobs increased.

In addition, two instruments that allowed flexible work hours played a key role in stabilizing employment. Working-time accounts enabled firms to adjust workers’ hours in response to short-term fluctuations in demand. This tool lowers labor costs for firms in a downturn, helping them weather the storm without laying off workers. An estimated 320,000 jobs were saved through the use of this arrangement. A separate short-time work arrangement was backed by a government subsidy. Firms paid employees for the hours they worked, while the Federal Employment Agency partly compensated workers for the hours lost during the downturn. The number of short-time workers sharply increased, peaking at more than 1.5 million in May 2009. An estimated 400,000 jobs were saved through the use of short-time work.<sup>a</sup>

Denmark highlights another model of labor market flexibility. The Danish “flexicurity” model is characterized by easy hiring and firing, compensated by a generous social safety net and active labor

market policies, which include job counseling and requalification, job training, and employment with wage subsidies. Light employment protections aim to promote firms’ competitiveness by reducing their employment costs. However, a generous social safety net has high coverage and high replacement ratios: low-income groups receive up to 90 percent of the income they had been receiving before they were laid off. Active labor market policies help people reenter the labor market.

After the global crisis, Denmark’s GDP growth fell to minus 5.2 percent in 2009. The unemployment rate jumped from 3.3 percent in 2008 to more than 6 percent in 2009 and hovered around 7.5 percent afterward. Most of the unemployed found jobs fairly quickly, however: 60 percent after 13 weeks, and 80 percent after 26 weeks. Nearly 70 percent of Danish workers surveyed say they are fairly or very confident that they can find a job if they are laid off—the highest rate for any European Union country.<sup>b</sup> Firms are also confident that they can find workers with the right skills with little cost or delay when the economy recovers.

While it is too early to say whether the German or Danish models coped well with the crisis and remain fiscally affordable in the longer run, they show that flexibility in the enterprise sector can both differ across countries and complement social safety nets. The choice of policy tools should be based on careful analyses of the institutional, historical, and socioeconomic contexts unique to each economy.

Source: WDR 2014 team based on Andersen and others 2011; Rinne and Zimmermann 2012.

a. Boeri and Bruecker 2011.

b. European Commission 2010.

government can channel public funding through public education institutions and build partnerships with the private sector to develop enterprise-based skills training. The government can also provide targeted support to help unskilled workers who are unemployed or employed in informal sectors with low-paying jobs, young people transitioning from school to work, and skilled workers transitioning between jobs to (re)integrate into the labor market. Specific policies may also be needed for certain groups of people. The provision of affordable and quality child and elderly care and the possibility of flexible working arrangements, for example, are particularly important for integrating female workers into the labor market.

*Use general revenue to finance social insurance.* In developing countries where the labor market is less formalized, however, social insurance that is based on mandatory contribution from employers and employees in the formal sector often protects only insiders, leaving the most vulnerable, such as informal workers and the unemployed, unprotected. In many cases, labor taxes can create market distortions and reduce firms' incentives to offer formal and stable contracts, particular for women, youth, and other vulnerable groups. In Mexico, for example, the close tie between employment and social insurance provision has made formal employment less attractive for firms.<sup>59</sup> It is a question for policy debate whether to use general revenue and user fees to fund basic social protection, such as basic health insurance and old age pensions (see the "Focus on policy reform" at the end of this Report).<sup>60</sup> Income taxes, property taxes, value-added taxes, and, in resource-rich countries, commodity taxes are potential sources of financing.

Such a shift in finance has the potential to help alleviate the undue burden on formal firms and move from protecting workers to protecting citizens. It can facilitate the government's efforts to meet its basic function of introducing a social protection system that provides basic services to all and supports the vulnerable, whether employed or not. Keeping benefits modest is often necessary for fiscal sustainability and for limiting moral hazard. In less developed countries, where the needs are larger and the capacity is more limited, fiscal sustainability and the efficiency of service delivery are likely to be more challenging. Tailoring the design of social protection schemes to country conditions given the stage of development of the labor market, institutional capacity, and the political environment is crucial to success. Building institutional capacity and strengthening accountability to enhance the efficiency of tax collection

and the allocation of public expenditures are often among the key areas in which to begin.

### *Pursue policies that improve both flexibility and formality in the longer run*

With sound regulations and incentives for flexibility in place, the government can pursue policies that improve both flexibility and formality. Policies aimed at increasing innovation and the share of highly skilled workers in the labor market require investments that typically come to fruition only in the long run.

*Increase innovation by addressing constraints in access to finance.* Access to finance for innovation can be a major constraint for enterprises. Because potential investors may not have the information an enterprise has about the likely success of a project, obtaining financing for innovative projects—which are especially uncertain—can be difficult, especially for new and small enterprises. The government can address this market failure by creating a business environment that includes appropriate resource support so that the private sector is able to provide financing at the three stages crucial for innovative enterprises: the early concept stage, when entrepreneurs need to develop ideas into viable concepts and products; the start-up stage, when entrepreneurs need seed funding to establish enterprises; and the growth stage, when entrepreneurs need venture capital to expand. The challenges for the state are to identify the best means for offering support depending on the prevailing business context and needs; to ensure that financing remains short term; to prevent the creation of dependent industries; and to contain the associated fiscal burden.

*Facilitate the adoption of technology and global collaboration.* Creating capacities and incentives to generate new-to-the-world knowledge will be relatively more important in developed economies, with industries at or closer to the technology frontier. In developing economies with less sophisticated technological capabilities and less abundant resources, the adoption of existing knowledge and its adaptation to local context might be relatively more important.<sup>61</sup> Indeed, external sources of technology account for 90 percent of the growth in total factor productivity in most developing countries.<sup>62</sup> The government can help to improve the links between research centers and universities and the private sector in research and product extension, support managerial skills training for entrepreneurs, and build the capacity to absorb new

technology in the general workforce. Depending on the country's innovative capacities, the government can adopt appropriate intellectual property rights policies, which provide incentives for innovation that can be widely adopted or adapted, and facilitate technology sharing between countries. Finally, the government can facilitate access to international sources of knowledge through trade, technology licensing, foreign direct investment, joint ventures, links to the diaspora community, and other international networks, such as those for research and development collaboration.

*Build the skills level of the labor force.* A more skilled labor force, whose workers can take on more sophisticated tasks and are equipped with more fungible skills, is a necessary condition for a flexible and formal enterprise sector. Education and lifelong learning are crucial for mitigating the negative impact and taking on the opportunities of technology innovation. In India, for example, a higher level of education of a district's workforce is strongly linked to higher entry rates of formal enterprises.<sup>63</sup> Skills shortages and mismatches are among the top concerns of enterprises. Worldwide, some 27 percent of registered enterprises consider the lack of skilled workers to be one of the major constraints to doing business.<sup>64</sup> Informational barriers are a primary contributor to this constraint—people do not know either what skills are needed or what training is available. For example, modern management practices tend to diffuse slowly between firms. But field experiments on large Indian textile firms show that increasing awareness of the necessary management skills—gleaned through free consulting on modern management practices—raised average productivity by 11 percent by improving quality and efficiency and reducing inventory.<sup>65</sup> The government can help the product market and the labor market work better by disseminating information about training and labor market outcomes.

*Build a regulatory framework that enhances worker, consumer, and environmental protection.* Once a sound basic regulatory framework is in place, governments can gradually add targeted regulation to spur competition and protect workers, consumers, and the environment. Basic workplace safety standards can be crucial to prevent the exploitation of workers.

**In an ever-changing world, a vibrant enterprise sector that allocates resources efficiently, promotes innovation, and protects workers and consumers is crucial to resilience and prosperity.**

The collapse of a factory building in Bangladesh in 2013, which killed more than 1,100 people, demonstrates the need for such regulation—the building was constructed illegally, with poor materials, and did not comply with existing building codes. Clear guidelines for testing and labeling consumer products, and for recalls in the case of product defects, can enhance consumers' confidence in the goods they buy. Environmental regulations are particularly important to prevent firms from socializing the costs of their activities. Consistent implementation of regulation is also a concern, because interest groups frequently use regulation as a tool to limit entry and handicap competitors. Without effective implementation, regulation can also become a governmental stamp of approval that does little to protect workers, consumers, or the environment. In these cases, regulation cannot fulfill its function of supporting people's risk management. To prevent regulatory capture, regulation must address specific problems and be implemented consistently.


### Putting it all together

#### *Helping the enterprise sector remain flexible as it gradually becomes formal*

In an ever-changing world, a key to resilience and prosperity is a vibrant enterprise sector that promotes innovation; reallocates resources efficiently; and protects workers, consumers, and the environment. By promoting the rule of law and contract security, the state can provide an enabling environment that encourages both flexibility and formality in the enterprise sector. Not only will flexibility and—in the longer run—formality increase the resilience of workers, firm owners, and investors to negative shocks and improve their ability to take advantage of opportunities, but these characteristics will also help drive economic growth and alleviate poverty.

Creating such an enabling environment remains a challenge, however, because of the trade-off in developing countries between flexibility and formality. In the short run, the informal economy can be a way out of poverty for many of the poor and vulnerable. In the longer run, formality strengthens the benefits of flexibility and ensures that the entire population can enjoy these benefits. Formalization based on

**TABLE 5.1** *Policy priorities to improve the enterprise sector's role in risk management*

	POLICIES TO SUPPORT RISK MANAGEMENT	
	FOUNDATIONAL	ADVANCED
<b>Knowledge</b>	Provide education and job-matching information	
	Basic skills and vocational training	Innovative skills training
<b>Protection</b>	Improve policy certainty and secure property rights	
	Streamline basic regulations, such as those on entry/exit	Spur innovation, including technology adoption/adaptation and innovation at the frontier
<b>Insurance</b>	Extend social insurance coverage, possibly delinking it from work status	
	Facilitate access to credit	Facilitate access to capital markets, for both debt and equity
<b>Coping</b>	Facilitate adaptability of wages and work hours	
	Develop insolvency mechanisms	Facilitate appropriate reorganization and avoid bailouts

Source: WDR 2014 team.

Note: The table presents a sequencing of policies based on the guidance of chapter 2 for establishing policy priorities: *be realistic* in designing policies tailored to the institutional capacity of the country, and *build a strong foundation* that addresses the most critical obstacles sustainably and that can be improved over time.

rigid enforcement of laws and regulations is not the solution, however: the entire enterprise sector would be worse off in a fully formal but sclerotic economy. What is needed is a business environment that is good for all enterprises, improvement of the regulatory framework, provision of public services, and enhanced worker skills to strengthen the advantages of becoming formal while retaining the advantages of being flexible. Done at the right pace and in the right sequence, the same policy elements that focus on increasing the flexibility of the enterprise sector can contribute to increasing both flexibility and formality in the long run.

Table 5.1 presents public policies that can improve the enterprise sector's socially beneficial role of risk management. Foundational policies include focusing on streamlining regulations and strengthening basic public services. For countries that already have those foundations in place, policy priorities should move on to facilitating innovation and the entry of efficient, productive enterprises, and easing the exit of inefficient, unproductive ones.

### *Following basic principles*

*Do not generate uncertainty or unnecessary risks.* Securing property rights and providing a predictable political and policy environment are prerequisites for the enterprise sector to play any beneficial role.

For this, improving legal institutions, reducing bureaucratic discretionary power, and strengthening transparency are fundamental.

*Promote flexibility.* Efficient labor and capital reallocation are crucial for the enterprise sector to adjust to ever-changing business conditions. Adaptable worker skills and clear mechanisms to resolve firm insolvency are needed.

*Provide the right incentives.* Competition, streamlined regulations, and fair enforcement can provide the incentives that the enterprise sector needs to remain flexible as it gradually becomes formal. Bailing out ailing firms is seldom an advisable policy action.

*Protect the vulnerable.* A social protection system that covers basic health and education needs can enhance the flexibility of the enterprise sector and protect the vulnerable, whether employed or not. The possibility of delinking social insurance from work status (employed/unemployed, formal/informal, urban/rural) deserves further consideration.

*Keep a long-run perspective.* While informality can act as a safety net to workers and provide flexibility to the enterprise sector in the short run, in the long run striving for formality should remain a goal for public policy.

## Notes

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6. Loayza and Rigolini 2011; World Bank 2012.
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8. Falco and others 2012.
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10. For seminal papers on the topic, see Azariadis 1975 and Baily 1974.
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14. Hsieh and Klenow 2009.
15. Caballero 2008.
16. Merotto, Kanematsu, and Huang, forthcoming.
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20. Gardner 2012.
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51. Bruhn and McKenzie 2013.
52. Caballero and others 2013.
53. Dräger and Marx 2012.
54. Alaniza, Gindling, and Terrell 2011.
55. Del Carpio, Nguyen, and Wang 2012.
56. Ayotte and Skeel 2010.
57. Fidas and Benhassine 2013 for the WDR 2014.
58. Bernal-Verdugo, Furceri, and Guillaume 2012.
59. Levy 2008.
60. See Ribe, Robalino, and Walker 2012 for a full discussion.
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62. Coe, Helpman, and Hoffmaister 1997.
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