November, 2009

Necessity vs. Opportunity Entrepreneurs in the Informal sector (Short Note)

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Necessity vs. Opportunity Entrepreneurs in the Informal sector

Some informal businesses are started to take advantage of business opportunities (opportunity firms) while others are started because the owner cannot find a satisfactory job (necessity firms). Comparing opportunity vs. necessity informal firms, this note finds that opportunity firms are more efficient and larger. They are also more likely to use external finance, and suffer less from infrastructure bottlenecks such as power outages. The key point in all these differences is that they apply to the manufacturing sector alone. With the exception of having more educated managers and more businesses located outside than inside household premises, opportunity firms in the service sector are not too different from the necessity firms in the same sector. In short, the motivation for starting a business matters for informal manufacturing but not much for service firms.

Schumpeter's idea of an entrepreneur is one who is dynamic and willing to take risks to exploit existing business opportunities and create new ones. However, many businesses in developing countries are started not to exploit business opportunities but because the owners cannot find satisfactory jobs. This is especially true of the informal sector, the focus of this note. For example, a survey of informal or unregistered firms in Ivory Coast, Madagascar and Mauritius conducted by Enterprise Surveys shows that 39 percent of the firms were started because the (largest) owner could not find a satisfactory job (necessity firms) while the remaining 61 percent were started to take advantage of business opportunities (opportunity firms). Using these data, this note compares opportunity vs. necessity firms with respect to their performance, how they operate and the sorts of problems they face. The comparison is useful for a variety of reasons. First, significant differences between necessity and opportunity firms in how they operate and the sorts of problems they face may signal distortions or inefficiencies due to the underlying motivation for starting a business. Such possible motivation related distortions do not necessarily go away by getting the informal firms to register, the usual policy prescription for the informal sector. Rather, what may be required are wage jobs for the necessity entrepreneurs. Second, anecdotal evidence suggests that informal firms face numerous problems in, for example, accessing credit and benefiting from government programs because their unregistered status. Policies aimed at bringing the informal firms within the fold of the formal or registered sector can be better targeted towards necessity vs. opportunity firms depending on how costs and benefits of registering vary across these firm groups. Third, it is possible that the choice of necessity vs. opportunity entrepreneurs may reflect underlying differences in the level of education or entrepreneurial skills of the individuals. In this case, it is entirely plausible that the extent of problem faced in accessing credit or power supply, for example, may differ between opportunity vs. necessity firms. Policies aimed at providing a better business environment to the informal firms should then be suitably adjusted to the underlying motivation for starting a business.

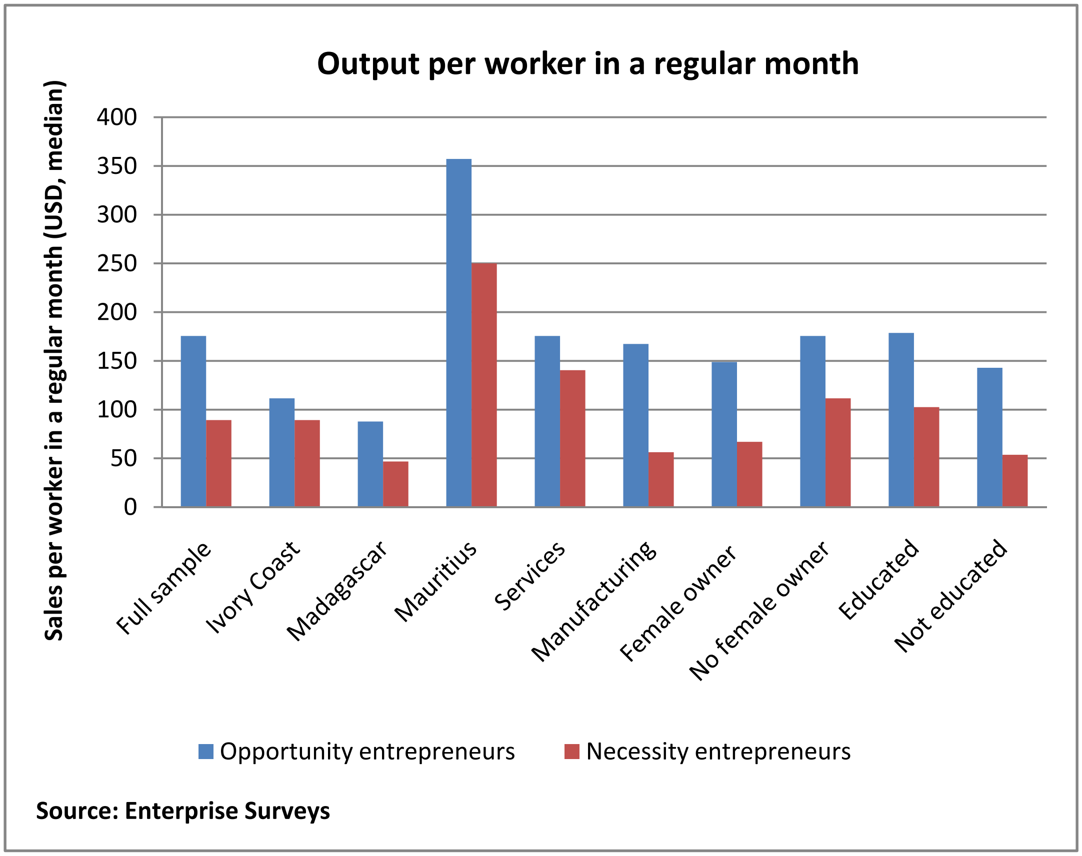
It is not immediately clear what to expect from a comparison of opportunity vs. necessity firms. On the one hand, opportunity entrepreneurs can be expected to be better motivated and more skilled at running a business so such entrepreneurs should face fewer problems in running a business and also perform better than necessity entrepreneurs. On the other hand, informal businesses usually operate on a small scale involving simple business activities. Therefore, it is possible that entrepreneurial skills and underlying motivation for starting a business may not matter much for the functioning of informal businesses. We treat the issue as an empirical one.

The results discussed below show mixed results. That is, opportunity firms perform better than necessity firms along some important dimensions but there is no difference between the two along other dimensions. More importantly, where differences do exists between the two firm groups, they are largely restricted to the manufacturing sector alone. It seems that the motivation for starting a business does not have much effect on how firms in the service sector operate.

1. Opportunity firms are more efficient than necessity firms

On average, total sales in a regular month for an informal firm run by an opportunity entrepreneur equal USD 304 or about 1.7 times the same for an informal firm run by a necessity entrepreneur. While the former is higher than the latter within various sub samples, there are significant differences in the magnitude of the difference. Total sales of an opportunity firm are 2.8 times the same for necessity firms in the manufacturing sector, 1.3 times in the service sector, 2 times in Mauritius, 1.4 times in Ivory Coast and 1.2 times in Madagascar.[i] Somewhat surprisingly, there is very little difference in total employment across necessity and opportunity firms. These findings imply that output per worker, a measure of firm efficiency, is much higher among opportunity relative to necessity firms. The difference is most pronounced for the sample of manufacturing firms where opportunity entrepreneurs generate 3 times more output per worker than necessity entrepreneurs compared with a much smaller figure of 1.3 times in the service sector (figure 1).[ii] These differences in efficiency levels survive even after accounting for differences between necessity and opportunity firms in firm characteristics such as age of the firm, managerial experience, difficulty in accessing finance, electricity usage and country and sector specific factors. One plausible implication of these results is that the underlying motivation for starting a business (necessity vs. opportunity) could be associated with X-efficiency of firms.

Figure 1: Opportunity firms generate more sales per workers than necessity firms



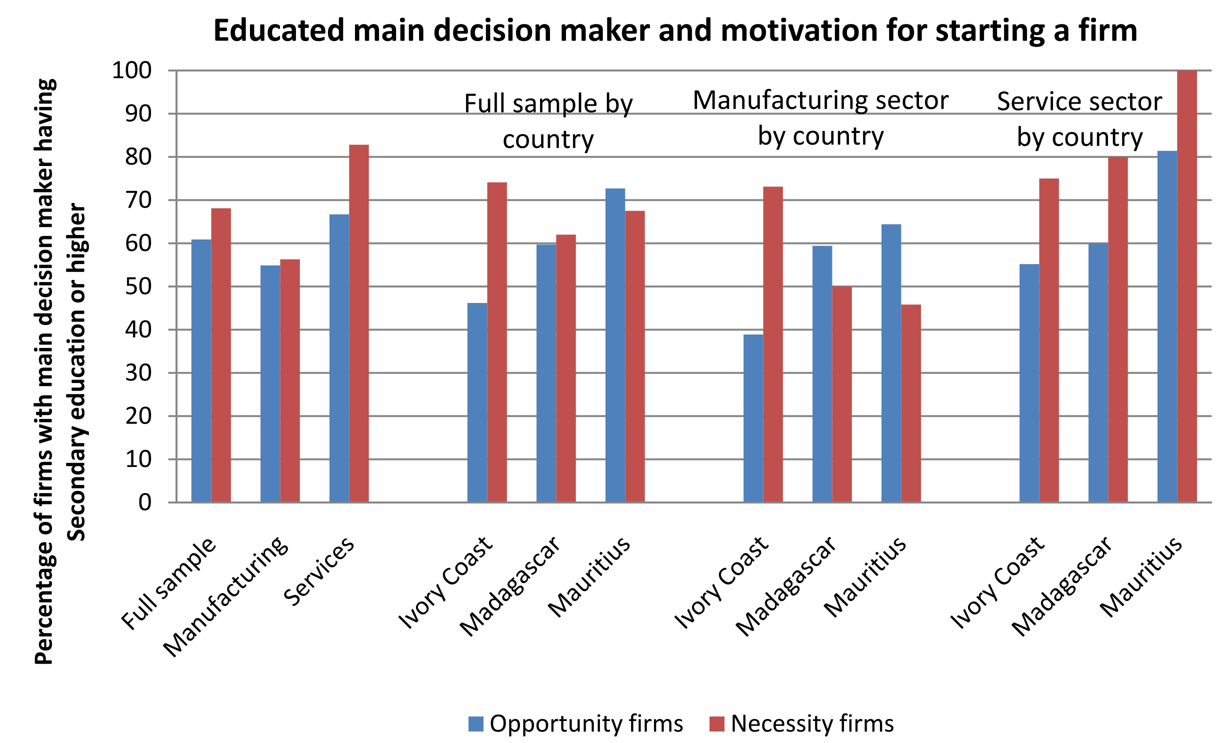
1) Educated implies the main decision maker has secondary education or higher while Not educated implies the rest (primary or no education). 2) Female owner implies that the firm has at least one female owner.

2. Opportunity firms are more likely to have educated main decision maker than necessity firms in the service sector

The relationship between the education level and the motivation for starting a business in the informal sector is not obvious. The more educated individuals may have aspirations for a high paying wage job in the formal sector but unable to find such a job they may choose to become necessity entrepreneurs in the informal sector. However, the more educated are also likely to be better aware of business opportunities and have the necessary skills to become opportunity entrepreneurs. The data show mixed results that vary sharply across manufacturing and service sectors (figure 2). Overall, necessity firms are more likely to have educated (secondary education or higher) main decision maker than opportunity firms although this difference is not much. However, as figure 2 suggests, this difference in the education level is entirely due to firms in the service sector. In fact, with the exception of Ivory Coast, manufacturing firms show a somewhat greater likelihood of an educated main decision maker among opportunity compared with necessity firms. A possible interpretation of these findings is that the educated individuals may be more hopeful than the uneducated ones of finding a job in the formal sector and hence may choose the service sector that is known to have lower entry and exit costs than the manufacturing sector.

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

Figure 2: Motivation for starting a business and education level of the main decision maker opposite relationships across sectors



Source: Enterprise Surveys

3. Opportunity firms have better access to electricity than necessity firms in the manufacturing sector

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

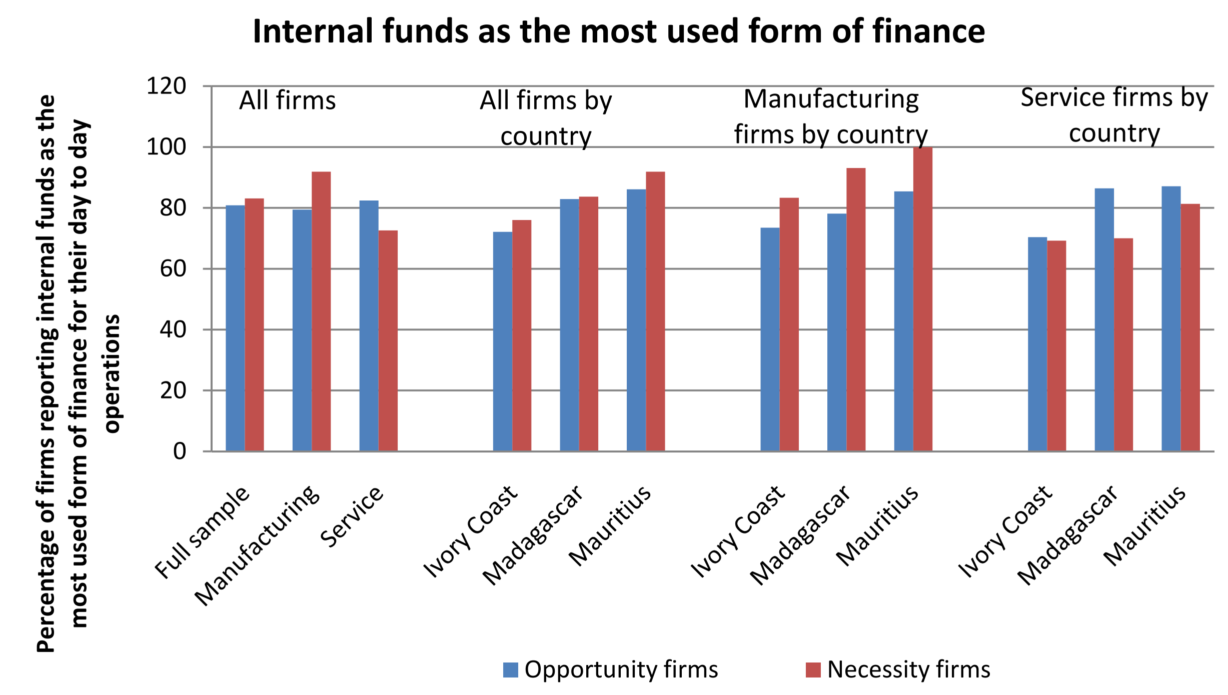
4. Access to finance is better for opportunity vs. necessity firms in the manufacturing sector

Anecdotal evidence suggests that access to finance is one of the biggest problems faced by informal firms. The Enterprise Survey also shows that over 53 percent of the respondents rank access to finance as the most important obstacle to their business from a list of 7 obstacles that includes (other than access to finance) access to land, corruption, crime, electricity, political instability and transport.

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

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

Figure 3: Internal funds as the most used source of finance for the day to day operations of firms is more common among manufacturing than service firms



Source: Enterprise Surveys

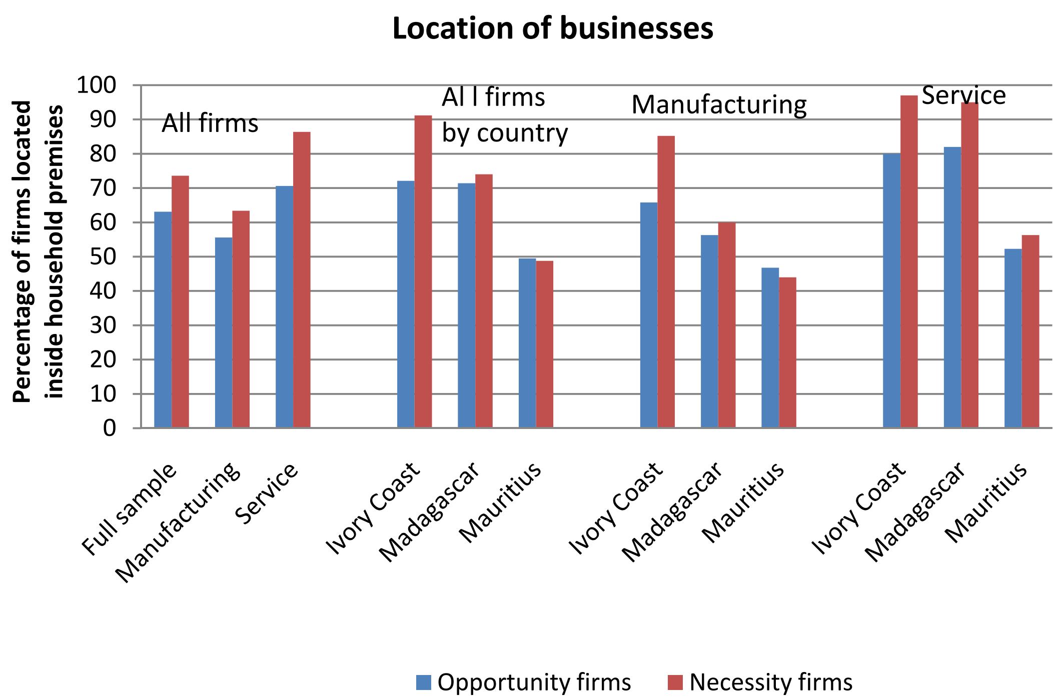
5. Opportunity and necessity firms differ in their location inside vs. outside household premises, but only within the service sector

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

We find substantial evidence of home-based businesses in our sample (figure 4). About 63 percent of opportunity firms and 74 percent of necessity firms located inside household premises. As figure 4 reveals, this difference between necessity and opportunity firms is largely driven by service sector firms. For example, 82 percent of opportunity firms compared with 95 percent of necessity firms in the service sector are located inside household premises in Madagascar. Corresponding figures for

Ivory Coast are 80 and 97 percent, respectively. With the exception of Ivory Coast, there is very little difference in business location across necessity and opportunity firms in the manufacturing sector.

Figure 4: Location of business inside vs. outside household premises varies between necessity and opportunity firms, but mostly in the service sector



Source: Enterprise Surveys

6. Country specific differences

Some differences between opportunity and necessity firms are restricted to individual countries. In Ivory Coast, there is a large difference in the proportion of opportunity and necessity firms that operate from outside than inside household premises and this holds for manufacturing as well as services firms. Specifically, close to 28 of the opportunity firms compared with only 9 percent of the necessity firms operate from outside household premises. There is no significant difference in these figures in the remaining two countries.

Madagascar stands out for the high proportion of opportunity relative to necessity firms that maintain their accounts separately from those of the household. Specifically, 34 percent of opportunity firms but only 12 percent of the necessity firms in Madagascar maintain business accounts separate from household accounts. The corresponding figures for Ivory Coast equal 46 and 36 percent and 59 and 53 percent in Mauritius.

Compared with necessity firms, opportunity firms in Mauritius show much less seasonality as measured by the ratio of total sales in the busiest to the slowest month. The ratio equals 2 for opportunity firms compared with 3 for necessity firms in Mauritius. Corresponding figures in Ivory Coast equal 2.4 and 2.9, respectively. In Madagascar, the ratio equals 4 for opportunity and necessity firms.

Motivation for starting a business can have significant direct effects on how businesses operate. It may also reflect a self-selection process whereby the more dynamic and enterprising individuals may choose to start a business to exploit business opportunities while the less enterprising ones, starting a business may be a waiting game until they find a suitable wage job. Therefore, it is natural to expect differences in the efficiency level and the other business characteristics depending on the underlying motivation. But precisely what are these differences and how important are they? This note provides some answers to this question for the informal sector in three African countries. The findings are mixed. On the one hand, opportunity and necessity firms show significant differences in the efficiency levels, use of infrastructure facilities such as electricity and in access to finance with the opportunity firms scoring over necessity firms. However, these differences are largely confined to the manufacturing sector with the underlying motivation being largely irrelevant for services sectors firms. Further, a number of firm characteristics considered important for the informal sector such as female ownership, use of paid vs. unpaid workers, seasonality, capacity utilization and crime and security related problems do not vary much with the motivation for starting a business. Hence, policy effectiveness can be improved by targeting different policy measures towards necessity vs. opportunity entrepreneurs but on a selective or issue by issue basis.

[i] Throughout the note, the service sector includes construction. The construction sector constitutes 1.03 percent of the sample and excluding this sector does not make any significant difference to the results discussed.

[ii] The difference in the output per worker between necessity and opportunity firms in the service sector is not statistically significant at the 10 percent level or less. The same for the manufacturing sector is significant at less than 1 percent level.