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Are bad business practices holding back small firms in developing countries?

David McKenzie, Christopher Woodruff

Better management practices are associated with better firm performance, and the quality of management practices is also associated with per capita income. This column explores the effect of business practices on small firms in developing countries. The findings indicate that better business practices are correlated with higher productivity, higher firm profits, and higher rates of survival. Poor business practices are holding back small firms in developing countries.

Management practices in large firms around the world have been systematically measured and reported in a series of papers by Bloom and Van Reenen (2007, 2010) and Bloom *et al*. (2012). These papers show that better managed firms perform better and that the quality of management practices is highly correlated with per capita income at the country level.

However, the modal firm in developing countries consists only of the owner, with no workers, and the extent to which better business practices matter for such firms is unclear. Bloom *et al*. (2012) note that "…the formal management practices we consider will not be so important for smaller firms…where more formal management practices may not be necessary." Moreover, despite the millions spent each year by governments and aid agencies on business training, a series of randomised experiments have struggled to detect impacts on firm sales and profitability (McKenzie and Woodruff 2014). This raises the question of whether bad business practices really matter for small firms in developing countries.

Measuring business practices in small firms

In a recent working paper (McKenzie and Woodruff 2015), we develop and test a set of 26 questions that measure business practices in small firms. These questions cover marketing (e.g. Did the firm advertise? Did it attempt to attract customers with a special offer? Does it ask customers what other products they would like it to sell?), record keeping (e.g. Does the firm record every sale and purchase? Has it worked out the cost of each item it sells? Does it have a written budget?), financial planning (e.g. Does it have a sales target for the next year? Does it have a balance sheet and profit and loss statement?), and buying and stock control (e.g. Does it frequently run out of stock? Does it attempt to negotiate discounts with suppliers?).

These questions were then given to more than 20,000 small firms in Bangladesh, Chile, Ghana, Kenya, Mexico, Nigeria, and Sri Lanka. In addition, in four of the countries the surveys were implemented multiple times, providing panel data that allows examination of the stability of business practices over time, and the relationship between initial business practices and subsequent business survival and growth.

As with large firms, there appears to be substantial dispersion in business practices across small firms within a country, reflecting large differences in the way small firms operate, even among those operating in the same sector with the same employment levels.

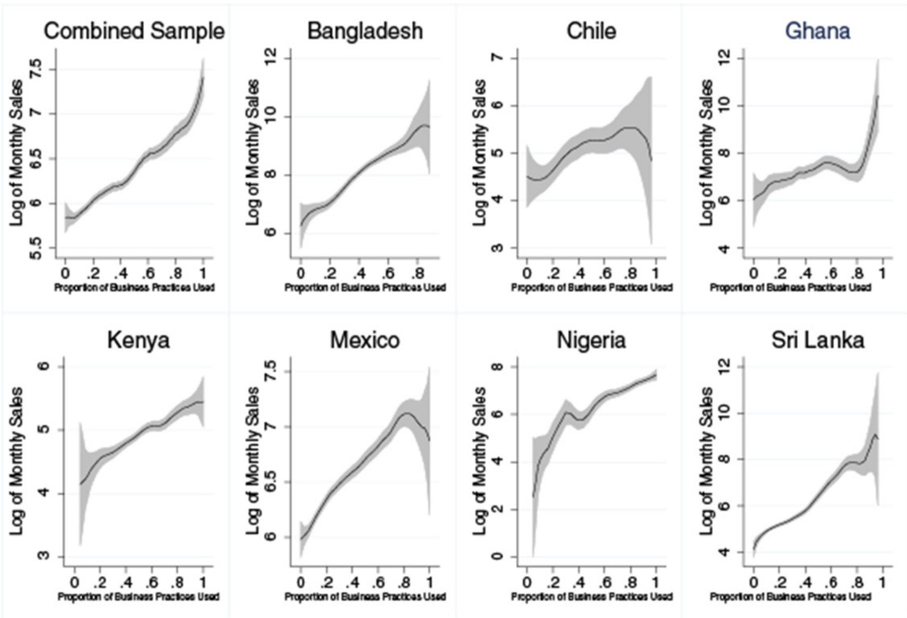
How much do business practices matter?

We find three main results:

- Better business practices are strongly correlated with higher productivity, sales, and profits in the cross-section.

Figure 1 shows this is true for the combined sample, and within each country. A one standard deviation improvement in business practices is associated with a 35% increase in labour productivity and a 22% increase in total factor productivity. The comparable relationships for much larger firms based on data from Bloom *et al*. (2012) are 43% and 17%, respectively.

Figure 1. Local linear regressions of log sales on business practices



- Better business practices today are associated with higher rates of survival and business growth over the subsequent year, and subsequent five years.

A one standard deviation improvement in business practices is associated with a 1.3 percentage point higher likelihood of survival (in a context where on average only 8.8% of firms exit in one year); 7% higher sales growth over one year, and with 15% higher sales growth over 5.5 years.

- Using recent randomised experiments suggests that these associations may be causal.

We compare the predicted increase in profits and sales from an improvement in business practices from these associations to those in five recent randomised experiments, and find in each case our predicted profits and sales lie within the confidence intervals of the experimental estimates. The reason for a lack of impact from many business training programmes then appears to be that they only result in rather small changes in business practices. A recent evaluation of a more intensive training programme by Anderson-MacDonald *et al*. (2014) is an exception – they use a ten-week course in South Africa, and obtain average increases in business practices of 26 percentage points.

Taken together, these findings suggest that poor business practices are likely to be holding back many small firms in developing countries. The challenge going forward for policy is then to develop more effective ways of changing these practices than the most frequently used business training programmes.

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About CAGE

Established in January 2010, CAGE is a research centre in the Department of Economics at the University of Warwick. Funded by the Economic and Social Research Council (ESRC), CAGE is carrying out a five year programme of innovative research.

The Centre's research programme is focused on how countries succeed in achieving key economic objectives, such as improving living standards, raising productivity and maintaining international competitiveness, which are central to the economic well-being of their citizens.

CAGE's research analyses the reasons for economic outcomes both in developed economies such as the UK and emerging economies such as China and India. The Centre aims to develop a better understanding of how to promote institutions and policies that are conducive to successful economic performance and endeavours to draw lessons for policy-makers from economic history as well as the contemporary world.

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