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Voeten, Jaap

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Finance and the Demand for Skill

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http://www.tilburguniversity.edu/dfid-innovation-and-growth/

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Sub-Saharan Africa experienced a decade of growth between 2000 and 2012, in which average annual GDP growth was over 4.5%. However, recent studies indicate that this growth has not translated into similarly high growth rates in job creation. Current growth comes largely from a small base of industry and the manufacturing sector, which will not come close to absorbing the millions of new workers entering the labour force each year. What is even more challenging is that many educated and skilled workers in Africa fail to find employment. The supply of highly skilled human capital who remain unemployed raises the question of whether there is a shortage of firm-level demand for skill in African economies.

Academic studies stress the importance of access to external funding for firm-level investment decisions, economic development and growth. What about the interactions between access to finance and employment creation for educated workers? There is little research addressing the effect of financing constraints on hiring decisions, especially of skilled workers.

In the framework of a DFID-funded research project entitled *'Enabling Innovation and Productivity Growth in Low Income Countries (EIP-LIC)'*, a team of researchers from Cass Business School (City University London) and Tilburg University investigated the role of financial constraints in firms' skilled labour demand. Specifically, using a small business survey from Uganda, the research explored whether skilled job creation rises with access to external finance. The original working paper is entitled *'Finance and Demand for Skill: Evidence from Uganda'* (2016) by Thorsten Beck, Mikael Homanen and Burak Uras[1].

Research approach and findings

The research shows that that the extent to which micro and small businesses expand skilled employment, as their sales and profits increase, depends significantly on access to external funding. Firms with positive performance and a bank loan hire more trained and experienced employees. Thus, growing and profitable small businesses create more jobs for trained and experienced workers - which is interpreted as demand for skill - if they have access to external finance.

The analysis does not reveal a significant relationship in the case of hiring casual employees or family and friends in the informal context, suggesting that financing constraints are more likely to bind in the context of employment contracts associated with experienced and trained employees with high human capital intensity. The results also suggest that financially constrained firms save their excess resources instead of investing in a more sophisticated and skilled workforce.

[1] The paper is accessible at the project's website (http://www.tilburguniversity.edu/dfid-innovation-and-growth)

Policy implications

The research findings underline the importance of well-developed financial systems for policies focusing on job creation. Firms with greater financial flexibility are more likely to hire skilled labour once their performance improves. For policy makers focusing on the challenge of creating formal and permanent jobs in a developing society, devising a complementary financial sector policy is equally important. The policy should go beyond helping firms directly to strengthening efficient financial systems and credit programmes as well.

Better access to external funding can thus be an accelerator of human capital investment demand and growth. Policy makers must also acknowledge that firms who are financially constrained save a greater proportion of their additional profits (or pay other expenses associated with financial constraints) and therefore cannot invest further in greater levels of employment; if access to finance is difficult, one could question the optimal effectiveness of employment creation policies.

For government, interest rates by state banks. would be a first point of attention in policy efforts to create formal employment of higher skilled labour. Against this background, policy monitoring systems for employment creation could include the degree of access to finance. Looking at it from the other side, formal credit policies and programmes could include formal job creation, since they are linked.

Better performance and financial access do not explain the hiring rates of informal employees, which include casual and family employees. Labour creation policies should thus acknowledge the different policy instruments for creating employment for higher educated and skilled workers on the one hand, and informal employment on the other.

In many developing countries, young people are educated and governments need to find ways to employ these highly qualified workers. With better access to finance, a firm's workforce can become more permanent and potentially more stable as well. As firms grow and become profitable, employment opportunities will increase for those who are formally trained, educated and more experienced. The policy relevance of such stable employment for higher educated staff centres on greater commitment of staff in firms. This will particularly positively affect firms' survival and innovation efforts, and is thus a vital issue for policy makers in many nations, and especially in developing countries.

This policy brief is the product of a research project funded by the British Department for International Development (DFID) entitled 'Enabling Innovation and Productivity Growth in Low Income Countries' (EIP-LIC)'. The project is implemented by Tilburg University (The Netherlands) and explores SME-level innovation in Low Income Countries (LICs) and factors that contribute to or limit its diffusion. Data collection and research collaborations take place in 10 African and Asian countries (Bangladesh, Ethiopia, Ghana, India, Indonesia, Kenya, Tanzania, South Africa, Uganda and Vietnam). The policy implications of research are presented in a series of policy briefs, targeted at a broad audience of policy makers within governments, business and development agencies.