CDC
Investment works

Summary article

Insight

How should DFIs and impact investors manage the challenges of job creation?

What's the issue?

In recent years, development finance institutions (DFIs) have expanded their traditional mission of job creation to include impact in areas such as education, health, gender, and the environment. Whilst all these areas are important objectives for DFIs, it is vital that job creation does not become overlooked. The creation of decent jobs is imperative to reducing poverty and improving quality of life in developing countries. And, because the market will not create enough decent jobs when left to its own devices, purposeful interventions are needed. The issue is, investing in job creation in Africa and South Asia presents a unique set of challenges.

To understand these challenges, we must first understand the nature of work in Africa and South Asia. In these regions, the majority of the working-age population is self-employed in agriculture or precarious informal activities. There is a shortage of stable, formal jobs that pay well, which forces people into unstable, informal jobs that pay badly. Therefore, while the unemployment rate in these regions is low, the poverty rate remains high.

These dynamics contribute to three main challenges for impact investors and DFIs:

- **Challenge 1: How to make investment decisions when outcomes are unclear.** Investments in job creation have both direct and indirect consequences, and outcomes often follow a crooked line. This makes it difficult for impact investors and DFIs to know, with certainty, where to make investments to maximise their impact. For example, is it better to invest in the expansion of firms that offer higher-quality jobs, to create more of those jobs and enable workers to move up the jobs ladder? Or is better to target firms that offer lower-quality jobs – and potentially employ more of the poor directly – and then try to raise the quality of those jobs?
- **Challenge 2: How to predict and measure the impact of investments.** In developing countries, the link between investments, growth, and jobs is poorly understood. In part, this is because we lack reliable tools for capturing the full impact of an investment. It is also because our target objectives are difficult to predict and measure. Where can we find evidence for whether an investment has accelerated economic transformation? How do we know the degree to which an investment has moved people out of precarious employment and into stable employment? How do we determine whether an investment is responsible for helping more productive firms add jobs and less productive firms shed them? It is difficult to find incontrovertible evidence for any of these outcomes.

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– **Challenge 3: How to choose between creating jobs and raising productivity.** Poverty declines when the nominal wages earned by the poor rise faster than the prices of the goods and services that they buy. Investments can support this outcome in two ways: One, they can create more good jobs that pay higher wages. Two, they can raise productivity, which will reduce prices if markets are competitive. However, there is tension between these objectives. When we create jobs in less productive firms, we perpetuate low levels of productivity. When we make investments that raise productivity, it can reduce the need for labour. But raising productivity is necessary to improve the quality of life for all, so we can't create 'more of the same' jobs if the goal is to reduce poverty.

80%

The percentage of jobs in Africa which are in the informal sector.

What are the key lessons?

To manage these challenges, impact investors and DFIs need to develop an accurate understanding of how the African and South Asian economies work; recognise the nuanced implications of their investments; and see the 'whole picture' when choosing when, where, and how to direct investments.

Key lessons to consider include:

1. **Pay attention to the quality of employment, not just the quantity.**

   In advanced economies, the goal of job creation is to reduce unemployment. In Africa and South Asia, where hardly anyone is unemployed, the goal of job creation is different. It is to replace informal, unstable jobs that pay poorly with formal, stable jobs that pay well. To that end, impact investors and DFIs should focus on creating more decent jobs in the formal sector and/or raising the quality of jobs in the informal sector – instead of focusing solely on the quantity of employment overall.

2. **Understand the implications of prioritising jobs over productivity, and vice versa.**

   Sometimes, it is preferable to invest in less productive and more labour-intensive firms. The reason: these investments can alleviate poverty if they create jobs for the poorest citizens and/or if they create opportunities for workers to switch jobs, including moving into better quality jobs. Other times, it is preferable to invest in more productive firms. These investments can help more productive firms add jobs and less productive firms shed them. It is not always obvious how impact investors and DFIs should decide between these options. However, since both raising productivity and creating jobs contribute to development, it may not be necessary to choose. Both can have a positive impact.

3. **Measure and strive for gross job creation.**
   Gross job creation – that is, the number of new jobs created before accounting for the number of old jobs destroyed – helps drive progress in two ways: it increases the number of decent jobs in the formal sector and it replaces bad jobs with better ones. This makes it a useful results indicator for DFIs to report. By contrast, net job creation – that is, increasing the overall level of employment – is a less useful indicator in developing economies that are close to full employment.

4. **Recognise domino effects but do not take them for granted.**
   When a firm expands, it adds demand for workers to the labour market. This extends beyond the firm itself as creating jobs in one firm can spur domino effects that result in other workers switching jobs. This, in turn, can increase productivity and improve worker conditions. Consider, for example, how creating one job could trigger three other workers moving jobs, including moving one person from precarious self-employment to formal employment. But these domino effects are hard to predict and cannot be taken for granted. Factors such as segmented labour markets can break the chains of workers moving jobs. In addition, we don't know exactly when and why job creation initiates domino effects that eventually benefit the most vulnerable people.

5. **Apply the 'What, Who, How Much?' framework.**
   Every time we make an investment in job creation, we should question who benefits and who loses out. At CDC, we apply a simple framework that asks: 'What are we doing? Who is benefitting? How much are they benefitting?' We do this to make sure that our investments are helping the most vulnerable and marginalised populations. We also do this to avoid making wrong assumptions about the impact of our investments. For example, we can't assume that investing in high-productivity firms will lead to inclusive growth, and we can't assume that every investment will help those most at risk. Which leads to another point: we should always try to bend the course of economic progress towards activities that benefit the poorest and most marginalised.

We shouldn't forget that domino effects exist. We shouldn't think that unless we can see a direct impact, we are having no impact. We need to make room in how we understnad the world and recognise the existence of spillovers.

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