

Why Doesn't Entry of Larger and More Productive Firms Drive Out the Many Small Firms in Developing Countries?



An expansion from zero to the average number of chain stores in a Mexican neighborhood (6.7) reduces the number of neighborhood shops by 15%. This reduction is not driven by increased shop exits but by decreased shop entries.



Shops retain their sales of fresh products and 96% of their customers, but customers visit shops less often and spend less on non-fresh and packed goods.



Shops survive by exploiting comparative advantages stemming from being small and owner-operated, such as lower agency costs, building relationships with the community, having a broader and tailored product mix, and offering informal credit.

CONTEXT

Microenterprises account for 84% of all firms and 40% of employment in developing countries. These firms are not only an essential source of employment and income, but they also provide access to goods and services for the poor. As economies develop, these small firms face increased competition from large and more efficient corporations with similar and often identical products. Microenterprises nonetheless continue to exist in overwhelming numbers. This phenomenon raises the question of the extent to which competition from large firms leads to reallocation through the exit of microenterprises and how the surviving small firms compensate for disadvantages in scale.

PROJECT

This paper studies a potentially key mechanism driving microenterprises' entry and exit: the effect of increased competition from large firms. In particular, it examines how one of the most prevalent microenterprises, sole-proprietor neighborhood shops, were impacted by the immense expansion of convenience chains in Mexico between 1999 and 2019. This paper assembles a rich microdata collection for the universe of shops, neighborhoods, and household characteristics.

Key Concept



MICROENTERPRISE

A business operating on a very small scale, especially with a sole proprietor and fewer than six employees.

RESULTS

Each additional chain store in a neighborhood reduces the number of shops by 3.85, implying that an expansion from zero to the average number of chain stores in a neighborhood (6.7) reduces the number of shops by 15%. The number of exits of shops does not increase, which means that the 16% reduction in the number of shop entries is the main driver of the decrease in the number of shops. At the neighborhood level, shops' total profits, revenue, value-added, inventories, total employed, and total hours worked declined between 20% and 30%. At the individual shop level, however, these adverse effects are only 0 to 7%.

Customers continue to purchase in shops, but they do so less and less often. The probability of neighbors purchasing in shops declines by 3.5%, and those who continue to purchase in shops do so 9% less often and buy 10% less. The effect on neighbors' purchases differs across product categories. Chains do not affect household expenditure in shops on fresh products such as fresh pastries, fruit, and vegetables, often sourced daily by shop owners from central markets (left side of the [figure](#)). Still, chains decrease household purchases in shops of packed and standardized products like sodas, milk, and bottled juices (right side of the [figure](#)).

Overall, households are more likely to purchase in the neighborhood shop if it is closer, they are buying fresh products, own their home, or use informal credit to pay. On the other hand, they are more likely to purchase in the chain if they are using electronic payments, they are buying alcohol and tobacco, they own a car, or they are richer.

POLICY IMPLICATIONS

While policymakers aim to increase productivity in their countries, this project highlights two important caveats to achieving these goals. The first is that the entry and expansion of high-productivity firms may not naturally increase productivity by replacing low-productivity firms. The expectation is that the entry of more productive firms will cause less productive firms to go out of business, but this is often not the case. In particular, less productive firms—even though they may have an absolute disadvantage—may still have comparative advantages that allow them to survive. If policymakers wish to accelerate an increase in productivity, they may need to implement policies to increase the outside options of low-productivity firms, thus nudging them to exit the market and make the resources they were using available to other, more productive firms.

A second and more important concern is whether increasing productivity should be considered a means toward achieving development goals and not an end in itself. In this context, having low-productivity firms may be desirable because these low-productivity firms provide amenities that are valuable to customers and that high-productivity firms do not provide. If consumers value having access to informal credit, a broader and tailored product offering, shorter physical distance to their homes, relationships with owners, and fresh and ripe products, they may be better off with the existence of low-productivity firms. Instead of focusing only on productivity, policymakers should consider whether the mix of firms in an industry maximizes welfare.

Key Concept



COMPARATIVE ADVANTAGES

The ability of an individual or group to carry out a particular economic activity more efficiently than another activity.

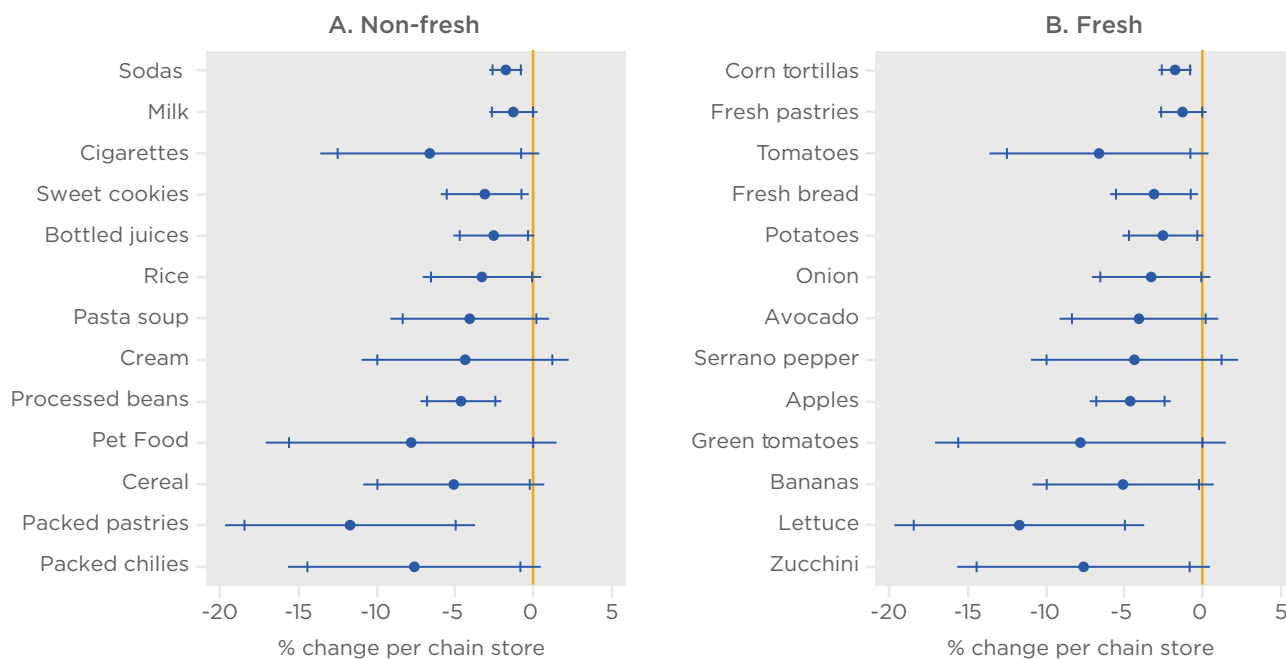
Key Concept



AGENCY COSTS

Costs associated with aligning employees' (agent's) incentives with the firm's (principal's). Such costs include those for measures to improve performance or reduce absenteeism.

Figure 1. Effect on Neighbors' Expenditure in Shops



Note: The figure displays the average effect on household consumption in neighborhood shops of an additional convenience chain in the neighborhood. The confidence intervals are 90% and 95%.



FULL STUDY

[Talamas Marcos, Miguel Ángel. 2023. "Surviving Competition: Neighborhood Shops vs. Convenience Chains." IDB Working Paper No. 1500. Washington, DC: Inter-American Development Bank.](#)

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