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Informality in Latin America: Interpretations, Facts and Opportunities

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Informality in Latin America: Interpretations, Facts and Opportunities

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1. Introduction

During three decades and a half informality has been at the core of numerous debates. Conceptual differences as well as political discrepancies have contributed to keeping alive this contribution of the ILO around the concept to the employment and poverty debate. From academicians, the debate moved to practitioners and international agencies, including lately an emerging interest of social and labor organizations.

Two factors probably helped a continuous interest on informality. First, the strong link between informality and poverty and underemployment, as well as, the important ability of the informal sector to absorb the most vulnerable groups in society - particularly, women and young people. Second, the capacity of adaptation of the concept to the emerging factors derived from economic and social changes in the world. Since prescriptions tend to be diverse and changing through time, this can also be read as one of the main liabilities of the concept. Nevertheless, the main guidelines for the core policy prescriptions surrounding informality have remained unaltered.

This paper deals with informality and its transition to modernity. The transit to formalization will enable those working in the informal economy to improve their chances of being included, become less vulnerable, and ensure a better performance of their activities. But this also requires a recognition of the fact that formality has been tailored according to the needs of those already there, rather than to incorporate the excluded. The mechanisms of formalization should be improved upon and adapted, as well as the capacity of the informal to effectively use these for empowerment purposes.

The objective of this paper is limited. It starts with a short review of the evolution of the concept of informality. In the second section, the size, characteristics and evolution of the informal economy in Latin America are analyzed. The third section contains a strategy for inclusion and opportunities for both enterprises and workers in the informal economy. The paper ends with a brief comment on the cultural change required to ensure the success of a strategy of inclusion and of opportunities.

2. Informality: from Sector to Economy

The notion of the informal sector was brought forward to the international scenario by the ILO in 1972 in an employment report on Kenya². The main contribution of the research was to highlight that the problem of employment in less developed country is not one of unemployment but rather one of employed people who do not earn enough money to make a living. They are the “working poor”; and economic informality was defined “as a way of doing things”. Those operating in the informal sector work in small units, produce or sell goods and services, and also employ members of the family and eventually, wage-workers. They are concentrated in urban areas and use little capital, while the division of labor is limited. The key conditions identified were ease of

² The mission directors were Richard Jolly and Hans Singer, both from the IDS at the University of Sussex. A previous paper was written by K. Hart, although published in 1973.

entry and the operation in unregulated or competitive markets. The outcome was low productivity and a reduced potential for growth. As a result, incomes are low and those occupied there constitute most of the poor population. The conceptual interpretation of “informal” was thereby made in opposition to formality and on the basis of the lack of access to markets and productive resources of those which it defined.

The conceptualization was based on a survival logic: since employment created in the formal sector was insufficient to absorb the increasing population, the only option available was for a particular group of individuals confronted to a lack of access to resources and markets to create their own jobs³. The logic of survival was not equivalent to a dualistic approach since early in the 1970s it was recognized that informality was connected to the rest of the economy, while the determinant issue was to identify the nature of the interrelationships at play (Tokman, 1976 and 1978). The main question was not whether the informal sector would grow - since that was clear given the rapidly growing labor force and the insufficient creation of new jobs -, but rather whether the expansion would be accompanied by higher or lower average incomes for those occupied in the sector.

As with all new concepts, the informal sector definition was questioned by many authors (inside and outside the ILO), on the basis that the informals constituted a workers reserve functional to the accumulation process of modern enterprises; they were many and available as needed at lower wage levels (Gerry, 1974; Bromley, 1978). Linkages were recognized and subcontracting relations were identified, although they were more intensive in countries at a more advanced stage of industrialization⁴. Later on another conceptual development was linked to the increasing productive decentralization associated with globalization and the changes in technology which made it feasible⁵. To deal with an increasing demand, modern enterprises adapt to the new environment by introducing more flexible production systems and by decentralizing production and labor processes. These changes reduce costs, externalize demand fluctuations and weaken the bargaining power of unions. The typical employment relationship between employers and workers within an enterprise was partly displaced by another employment relationship, not always visible or clearly defined, that could also mean multi-firms involvement. Hence, obligations and responsibilities became diffused resulting in higher flexibility and lower labor costs but for the workers it meant reduced wages and lost of protection.

Another research effort allocated a growing importance to the informal sector’s operation beyond the prevailing legal and institutional frameworks⁶. This coincided with the reform period guided by the Washington Consensus, which emphasized the need to liberalize the economy and to diminish government intervention and particularly, regulations and bureaucracy. Heavy regulations and inefficient processing introduce barriers for business development and, in the case of the micro-enterprises, force them to operate informally. As argued by De Soto, inadequate regulations, designed for formal enterprises affect the legal recognition of assets of the poor and

³ In Latin America this perspective was further developed (Tokman, 1995) introducing informality within the employment analysis in a structural framework as developed by Prebisch (1970) and Pinto (1965), among others.

⁴ Lubell, (1991) arrives to this conclusion based on the research undertaken under the World Employment Programme of the ILO in Africa, Asia and Latin America. His survey reviewing studies and policies undertaken at the OECD Development Center is an important contribution on the topic.

⁵ Portes, Castells and Benton (1989).

⁶ De Soto, (1986) and Perry, G. *et al.* (2007).

result in exclusion from property, while “paper walls” and long processing times involved conspire against formalization. Furthermore, according to a recent interpretation by the World Bank, informality results in exit rather than exclusion, since the informals “voluntary” opt-out of formality given the existing barriers.

Thirty years after the ILO introduced the concept of informal sector it expanded the concept from the sector to the economy. The informal economy was defined as “*all economic activities by workers and economic units that are - in law or in practice - not covered or insufficiently covered by formal arrangements*”⁷. It includes both, enterprise and work relationships, and did not eliminate the informal sector but expanded it to include all workers that are not sufficiently covered by labor laws even if they are employed in formal units of production. It provides a framework to capture the spurious decentralization that is associated to externalization or even subcontracting inside formal units of production.

Beyond the debates and different analytical perspectives that have prevailed during the last 35 years the concept(s) of informality have contributed to the understanding of employment and development problems and to identify strategies and clarify priorities.

The debate will surely go on but it is time to capture the milestones of an evolving concept. Informality started as an issue related to urban problems and urban planning. It was then upgraded by the World Employment Programme of the ILO by placing it in the context of employment, poverty and development in developing economies around the world. In the 1970s and up to the mid-1980s, informality was crucial to understand the employment problem in developing countries and to learn why it adopted less visible forms and particularly, why growth was not ensuring a convergence path to the situation prevailing in developed countries. The informal sector debate served to advances in the understanding of the dynamics of growth and employment creation from multiple perspectives, capturing the most relevant structural features of underdevelopment and particularly, the determinants of poverty and the mechanisms of survival that people were forced to create.

From the mid 1980s, and particularly during the 1990s, the world economy registered fundamental changes. Instead of shifting the debate away from informality, new perspectives were introduced on a concept that was, by then, beyond the academic discussion and was becoming accepted politically. Policy instruments were devised accordingly. Globalization and technological change affected the growth model of developing countries. Developing countries also had to confront the deep crisis caused by the rise of oil prices in the 1970s and, in the 1980s, to a crisis caused by the heavy indebtedness incurred and facilitated by the high liquidity of the international monetary system. The change of the growth model was reinforced by a macro-economic crisis, particularly in Latin America: economic reforms were introduced during the 1980s; labor reforms searching for flexibility were introduced while decentralization of production and labor was promoted to improve the competitiveness capacity.

As a result of changes, protection in the formal sector was eroded and jobs became more unstable. This was increasingly visible and affecting not only the structurally excluded in the informal sector, but also those working in small and medium size enterprises and causing those participating in decentralized production chains to becoming more vulnerable to economic fluctuations and emerging risks. In parallel, the expected upward

⁷ ILO (2002) and (2002a), p. 53 of the ILO Resolution as approved by the members.

mobility to more stable and protected jobs weakened. The recognition of the workers in this situation as informal but beyond the sector was captured by expanding the definition of informality to the economy.

3. The Informal Economy: Some Facts for Latin America

The size of informality can be estimated, following the definition adopted for the informal economy. In this section an attempt will be made to assess this size on the basis of household surveys for sixteen countries of Latin America⁸. First, we measure the size of the informal economy by adding unprotected waged employees in establishments of more than 5 employees to the informal sector. We restrict the analysis to urban areas because of constraints on data availability. We set out how the informal economy has evolved for the last fifteen years as well as the structure of the informal economy. The latter is explained by two main components: exclusion and precariousness. The data are aggregated for the region as whole, but some indications on country variations are included to highlight the prevailing heterogeneity. Second, the structure of the informal sector is analyzed in what follows. Specifically, differences in incomes within the sector are considered to examine the exclusion and voluntary decisions (or exit) hypothesis which we have set out above. Finally, as unprotected workers in formal units of production closely relate to the structure of labor contracts and the differences between contracts, we also examined the contract structure.

3.1 Size, Evolution and Country Diversity of the informal economy

The informal economy in Latin America accounted, in 2005, for 63.3 percent of non-agricultural employment. The informal sector then reached to 50.7 percent, while around 12.6 percent were unprotected workers in formal establishments. Eighty percent of the informal economy was in the informal sector, but 22 percent were informal workers employed in the formal enterprises. The informal economy expanded from 57 to 63.3 percent of urban employment between 1990 and 2005 as a result of increases in the informal sector and of the number of precarious workers in formal enterprises. Although they both contributed to the expansion of the informal economy, the latter grew faster than the former (Table 1 and Graph 1).

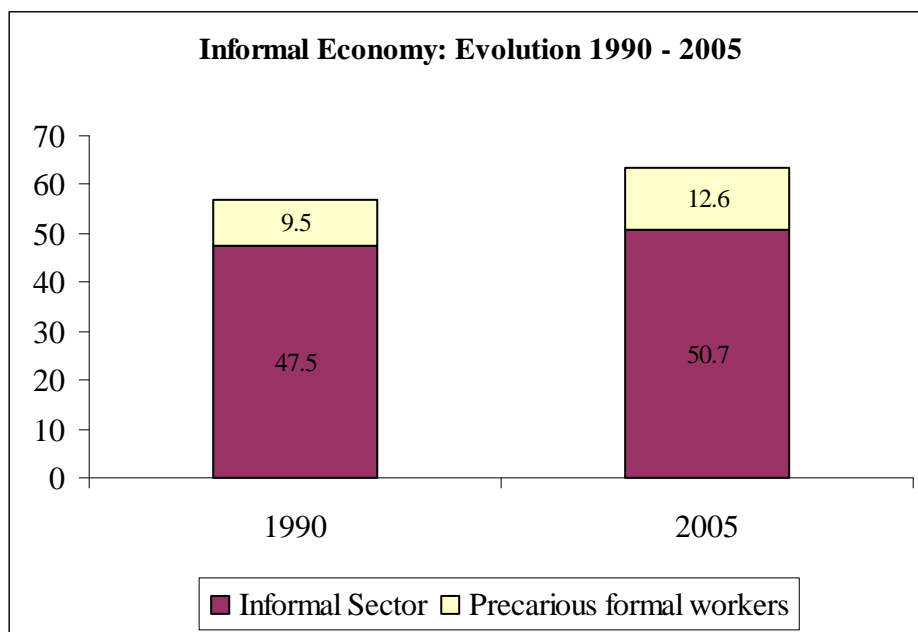
Table 1. Informal economy in Latin America, 1990-2005 (as percentages of urban employment)

	1990	2005
Informal Economy	57.0	63.3
Informal Sector	47.5	50.7
Precarious formal workers	9.5	12.6

⁸ Data are from CEPAL and refer to national households' surveys. The countries considered include Argentina, Bolivia, Brazil, Chile, Costa Rica, Ecuador, Nicaragua, El Salvador, Guatemala, Mexico, Panama, Paraguay, Peru, Dominican Republic, Uruguay and Venezuela. As the relevant questions are not included until the more recent surveys the number of countries included will be added to each table presented.

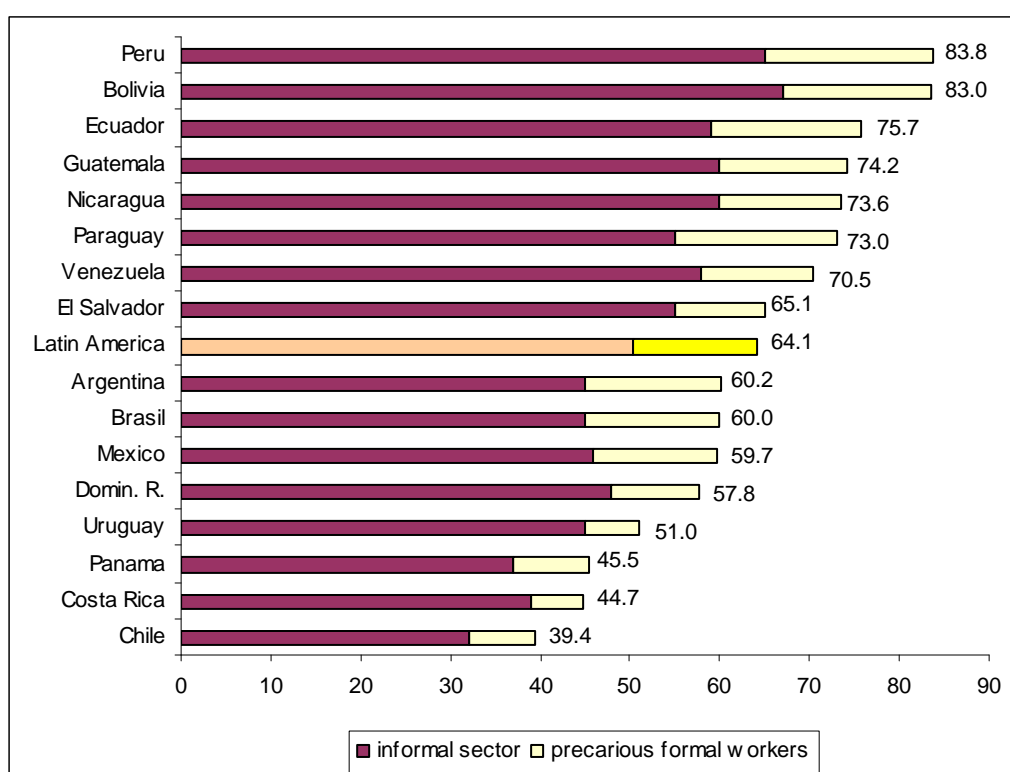
Sources and notes: ECLAC on the basis of households' surveys and Tokman (2007). Data include 16 countries in 2005 and in 1990 for the informal sector. Precarious formal workers in 1990, refer to data for 5 countries. The percentage for 2005 does not significantly differ for 5 or 16 countries. It refers to the arithmetic mean.

Graph 1. Structure of the informal economy, 1990-2005



The situation varies according to countries from a country like Chile that registers around 39 percent of urban employment in the informal economy, to Bolivia and Peru, where the percentage is between 87 to 84 percent respectively. Three groups of countries can be distinguished in the data. At one extreme are most of the Andean and central American countries with between 72 and 87 percent in the informal economy (Bolivia, Peru, Ecuador, Nicaragua and Guatemala). At the other extreme, Chile, Costa Rica, Panama and Uruguay register an informal economy that concentrates between 38 and 50 percent and a third intermediate group of countries, ranging from Argentina, Brazil, Mexico with around 57 percent to El Salvador with 65 percent and including also Venezuela and the Dominican Republic (graph 2)

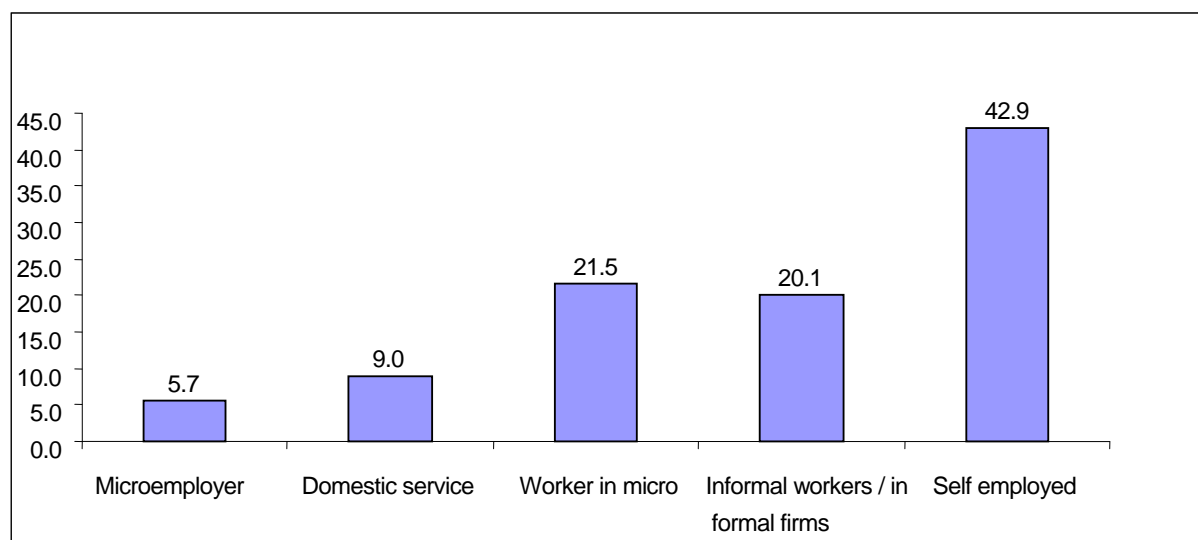
Graph 2. The informal economy by country, 2005



Source: ECLAC on the basis of household surveys of each country, 2005.

Differences in size and structure of the informal economy between countries is high, but in addition labor insertion by employment categories adds a new dimension to diversity. Self-employment accounted for 43% of informal employment in 2005 constituting the largest proportion, closely followed by wage workers that amounted to 42%; 9% was in domestic services and the remaining were micro entrepreneurs. Wage workers are less homogeneous than is suggested by percentages, since more than half among them are employed in micro enterprises and 48% are occupied in formal establishments in a precarious situation (see, graph 3). The data available suggests that the share of self employment has decreased between 1990 and 2005, both as a result of a relative decrease of self employment and an expansion of informal wage workers.

Averages hide different country situations. Self employment accounts for more than half of the occupation in the informal economy in countries like Peru, Bolivia, Dominican Republic and Venezuela, while it is less than one third in Argentina, Mexico and Costa Rica. This suggests that the greater the share of the informal economy in the economy and particularly, the informal sector, the more significant is the existence of independent employment. The share of wage workers in the largest countries of the Region (Argentina, Mexico and Brazil) is above average and in the case of the Argentina represents more than half of informal employment.

Graph 3. Informal economy in Latin America, 2005

3.2 Exit or Exclusion

A recent study on informality in Latin America by World Bank experts (Perry *et al.*, 2007) contributes an additional factor to explain informality. It remarks on the voluntary nature, particularly in the case of independent workers, of those who work informally because the income earned is higher than what they could obtain by working within the legal framework. It claims that this is the case in countries where access to social protection benefits in formality is limited and there are universal alternatives or non-contributory programs that can compensate for the lack of coverage. Exit is, in other words, a rational decision in an environment of inadequate and costly regulations and co-exists with exclusion resulting from labor market segmentation and constraints to doing business on a small scale.

We have also argued (Tokman, 1978) that a family micro enterprise could also constitute an efficient option in a context of scarce resources and jobs by better responding to the needs of the family. This is so because it allows matching the time available in the family with the scarce resources available. It allows mobilizing family labor, introducing consistency among functions at the enterprise and the household. Women can reconcile the roles of housewife, mother and work and for son and daughters of schooling and work. Such work further allows the use of the family house as the business place and the means of transportation available for domestic use to also respond to the micro enterprise requirements. It introduces a degree of flexibility that makes it feasible to introduce consistency between roles and resources. This is a usual case of small business particularly, in retail trade.

A guiding motif in the exit interpretation would be the higher income earned by opting for this solution. How do the data available on income differentials between sectors and occupational categories suggest on this hypothesis?

On average for Latin America, those occupied in the formal sector perceive an average income 80% higher than that received by those working in the informal sector. This is in line with productivity gaps among units of

production according to size, differences in human capital and collective bargaining capacity, non-existent in informal enterprises. Independent workers and informal micro-entrepreneurs' income is 28% higher than the average income of the informal sector and 57% higher than the wage of informal workers in informal enterprises. However, this wage is 13% lower than if a person is employed as a worker in a firm of more than 5 employees. There is an incentive to formalize, although at the cost of losing autonomy and the advantage could disappear if there is some partial time available for work in the family that can be mobilized.

However, differences between independent workers and informal micro-entrepreneurs are significant. A non-professional independent worker could, on average, triple his/her income if s/he could become a micro-entrepreneur. With a present income 16% higher than that (the wage) of an informal worker, there are no incentives to shift, but it could be attractive to a wage worker in a formal firm as a shift would allow an income increase of 36%.

Exit is not supported by the data. On the contrary, informal micro-entrepreneurs would not have incentives to move to a wage worker position, since even if formal, it would reduce its present informal income by one third. His/her options would be to let the micro-enterprise grow until it eventually becomes formal, since there is a direct strong correlation between formality and firm size. This is observed in micro-enterprises and with higher intensity, in bigger size firms.

Table 2. Income differentials between independent and wage workers, 2005 (ratios)

Country	Self-employed/ Worker<5	self-employed/ worker>5	self-employed/ Employer<5	self-employed/ employer>5
Argentina	2.17	1.35	0.38	0.21
Bolivia	0.86	0.40	0.31	0.11
Brazil	1.27	0.70	0.32	0.16
Chile	2.36	1.30	0.32	0.15
Costa Rica	0.89	0.53	0.50	0.29
Ecuador	1.00	0.60	0.36	0.17
El Salvador	0.96	0.62	0.33	0.28
Guatemala	0.82	0.37	0.26	0.10
Honduras	0.59	0.30	0.24	0.13
México	1.74	0.93	0.35	0.09
Nicaragua	1.05	0.59	0.33	0.05
Panamá	0.84	0.45	0.30	0.14
Paraguay	0.83	0.47	0.27	0.07
Peru	0.89	0.40	0.30	0.09
Dominican Republic	1.53	0.79	0.38	0.25
Uruguay	1.29	0.64	0.34	0.21
Venezuela	0.67	0.42	0.14	0.08
arithmetic average	1.16	0.64	0.32	0.15

Source: CEPAL, based on household surveys of each country

Note:

self-employed/worker<5: Independent worker relative to wage worker in micro enterprises with less than 5 employees

self-employed/worker>5: Independent worker relative to wage worker in enterprises of more than 5 employees

self-employed/employer < 5: Independent worker relative to employer in micro enterprises with less than 5 employees

self-employed/employer > 5: Independent worker relative to employers in enterprises of more than 5 employees

Another recent research policy paper published by the World Bank (de Mel, McKenzie and Woodruff, 2008) also contributes to the understanding of the occupational options and behavior of the self-employed in the case of Sri Lanka. The authors' findings support our view that informal activities and in particular, that own account workers are mostly marginalized and waiting for an opportunity for wage work in the formal sector to arise. The informal economy arises from the failure of the economic system to create enough productive employment and particularly, stable and protected waged work in formal enterprises (Tokman, 2001). It is not a voluntary decision, but rather a forced one given the lack of sufficient wage work. Data on labor histories showed that few of the own account workers say that they have ever been waged workers, while previous wage work is more common for enterprise owners⁹.

In addition, they argue that own account workers are not entrepreneurs that would evolve to owners of larger enterprises if the constraints they face (particularly the lack of access to credit and barriers of entry) were raised. Around two-thirds of the own account workers would be classified as wage workers rather than entrepreneurs. They also found that ability, motivation and competitive attitudes are determinants in differentiating owners of enterprises hiring between 5 and 50 employees and own account workers. On average, own account workers are more like waged workers and the lack of growth derives from their lack of ability or desire to grow, rather than the lack of finance.

Only a minority of the own account workers have characteristics similar to owners of enterprises, but the percentage is still significant. This leads the authors to suggest differentiated policy measures. The focus for the majority of own account workers, unlikely to grow, should be on increasing income. For the remaining one-third with greater prospects for growth, the aim should be to promote the transition to employer status.

3.3 Informality, Labor Contracts and Social Protection

Access to protection requires a formally recognized employment relation. This is acquired through a written labor contract. Without it, a worker is not recognized. In 2005, 37.7 percent of the wage workers were employed without contract in Latin America. Whilst a great proportion of those were found in the informal since it affects to 68 percent of the workers in the sector, 26 percent of the workers in formal establishments were also without a contract (see graph 4 and 5, first row).

According to the scarce data available on contracts, the situation has not improved. Instead there has been an increase in the percentage of workers without contracts or without full protection of around 4 percentage points

⁹ In another paper (Tokman, 2008), we discussed mobility patterns and job preferences on the basis of household surveys for 17 Latin American countries. The evidence does not provide support to the exit hypothesis.

between 1990 and 2005, entirely explained by the workers under this situation working in formal establishments but included in the informal economy. Data available for Peru, Argentina and Chile, show a significant increase in the percentage of wage workers employed without contracts or under fixed term contracts during the 1990s (Tokman, 2006). According to household surveys carried out around the year 2000 this trend continued and the percentage reached 74 percent in Peru and 35.8 percent in Argentina. A study of un-registered private employment in Argentina showed that in 1990, 29.6 percent were in that condition, increasing to reach a maximum of 43.4 percent in 2004 and later decreasing to 39.8 percent in 2005¹⁰.

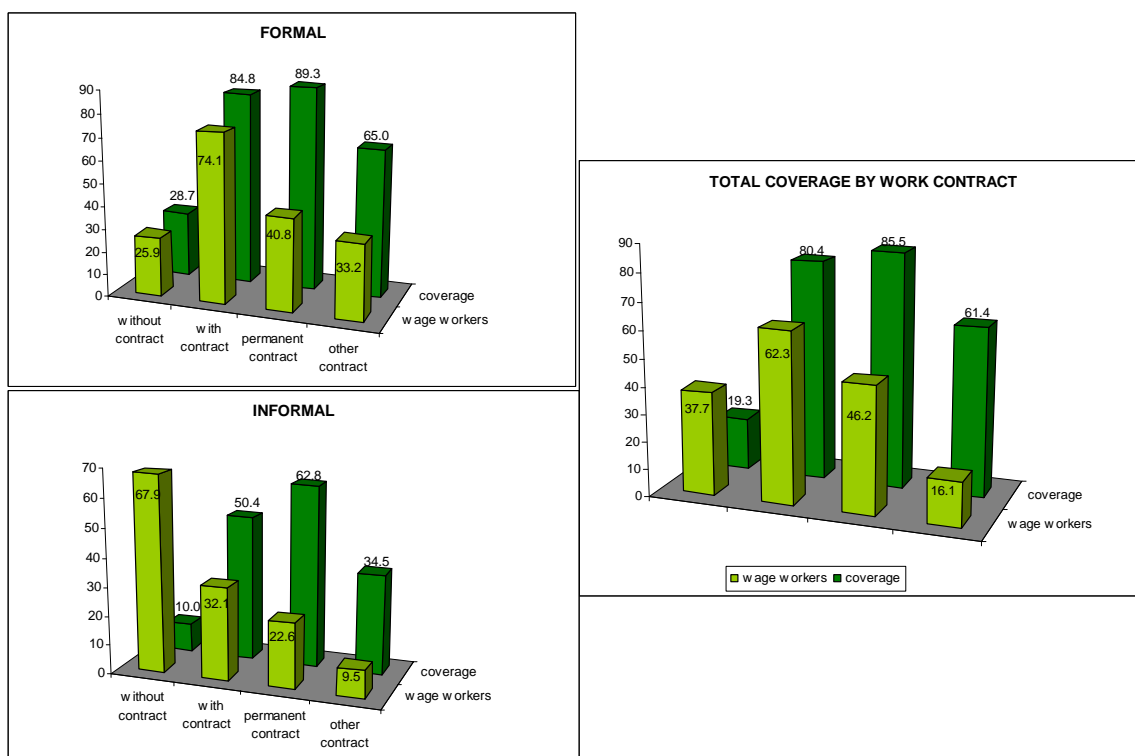
The growing absence of a contract is associated with labor reforms being driven by a search for flexibility and being applied in an environment of weak labor inspection, which further weakened given the widely accepted diagnosis attributing rigidities to the labor legislation in many countries. This was interpreted as a signal by the employers to hire new entrants without contracts. In addition, the structure of contracts has changed against the prevailing permanent contracts introducing atypical arrangements to reduce the costs involved as a means to increase flexibility and facilitate adjustment to obtain competitive gains in international markets.

Differences in social protection coverage for those workers with or without written contracts are substantial, independently of whether they are employed in the informal or in the formal sector¹¹. On average, 19 percent of the workers without contracts have access to social protection, while the probability of access to protection is more than four times higher for workers with contracts. The probability of being protected in the case of workers without contracts in the informal sector is 10 per cent, while the gap with workers with contracts in the same sectors is 5 times. Working without a contract in the formal sector yields a probability of 29 percent of being protected and the gap with a worker with contract in the same sector is almost three times higher (see graph 3 and 4, second row).

¹⁰ The data refers to Gran Buenos Aires for the period may 1990 to the fourth trimester of 2005. Ministerio de Trabajo, Empleo y Seguridad Social, 2006.

¹¹ Social protection is measured as proxy by the percentage of workers in each type of contractual situation that contributes to old age pensions.

Graph 4. Social protection coverage by contractual situation



Source: ECLAC on the basis of household surveys for 16 countries

The type of contract also matters to determine access to social protection. The permanent contract, covering around 70 percent of the workers with contracts, ensures a very high probability of being covered by social protection. Near 86 percent of the workers under these contracts, are likely to benefit from social protection. Eighty nine per cent of the workers with permanent contracts in the formal sector have access to social protection; while the percentage is 63 for those under similar contracts in the informal sector. Working under atypical labor contracts result in a loss of protection since only the 61 percent of the workers on average have access. Sixteen percent of the wage workers and around 30 percent of those with contracts are in this situation. Both the probability of coverage and the percentage of wage workers under atypical contracts are higher in the formal than in the informal sector. One third of the workers in the former are employed with atypical contracts and 65 percent among them have access to social protection; in the informal sector less than 10 percent of the workers possess this type of contracts and the probability of being protected is 34 percent.

The data analyzed suggests that atypical contracts are more demanded by formal enterprises, that there is a loss of protection but the probability of coverage is not marginal; and furthermore, that for a wage worker having a permanent contract in an informal micro-enterprise it would be attractive to work under an atypical contract in a formal enterprise, given the greater chances of being protected.

4. Towards a Strategy for inclusion and opportunities

Informality and social exclusion reflect poor access to resources, low incomes and vulnerability. They also constitute a market and a policy failure and particularly, a citizenship failure since the people affected are denied entitlements to their economic, social and labor rights. These are requirements for social cohesion. A renewed strategy for inclusion of those working in the informal economy is needed (Tokman, 2001, 2006 and 2008).

The informal sector includes both enterprises and families engaging in productive activities, and the likelihood of progressing towards formal-sector status is determined mainly by a productive unit's capacity for growth. Similarly, the extent to which employment relations in the informal sector should be recognized and regulated depends on enterprises' ability to comply with obligations, which are directly linked to their economic success. For this reason, the development of informal-sector production and progress in the labor sphere must be addressed simultaneously. Successful experiments in support of informal-sector productive activities include improving access to productive resources (capital and credit, skills and training, technology) and to markets (organization and location). Nevertheless, the greatest potential for a major impact throughout the system lays with the regulatory framework for both enterprises and labor relations in those units.

Workers in the informal economy are also directly or indirectly employed beyond the informal sector in formal enterprises subject to insecurity and lack of labor and social protection. Misguided labor reforms or ill-designed regulations in weak enforcement environments should also be corrected to improve compliance. Finally, protection of the workers in the informal economy and especially, those in the informal sector should be examined in relation to their contributory capacity to ensure adequate levels of coverage of health and old age risks. Institutional reforms will then be needed.

A strategy for inclusion and opportunities could include the following five pillars: the development of production and regulation of informal sector activities; labor rights in enterprises with limited ability to pay, insecurity and vulnerability in atypical contracts; definition and regulation of ill-defined labor relationships and, social protection for informal workers and producers.

4.1 Regulation of Informal Activities

Regulations designed bearing in mind larger enterprises and more organized sectors appear inadequate for the needs and conditions of micro enterprises. There is a need for adjustment and simplification to facilitate compliance. On the other hand, bureaucratic difficulties hold up requests to open or close informal business activities, because the numerous laws and regulations involved and state bureaucracies are inefficient. As pointed in an ILO study (2006) whereas these regulations apply generally to all enterprises, the smaller ones are disproportionately affected as they do not have the means to overcome the obstacles to doing business.

In Latin America, there are 2.6 times as many such regulations as in the OECD countries and more than there are in the Asian countries; only in Africa and in the Middle East are such regulations more numerous (Loayza, Oviedo y Servén, 2006). Although there have been marked improvements in trade opening and financial sector modernization, the largest backlog is found in the regulations governing business licenses.

Simplifying bureaucratic procedures and registration regimes can contribute to diminish access barriers. There is also room for action to adapt the mechanisms for formalization. De Soto suggested to simplify the release of a legal property title and to adapt it to prevalent conditions of *de facto* ownership as a mechanism to have access to credit. Recognition of entitlements can constitute the collateral requirements and contribute to mobilize

property to open credit access. The separation of assets between the individual and the entrepreneur is usually conducted by creating firms of a diverse legal nature and diverse degrees of complexity. Requirements associated with this simple but crucial change to the patrimonial responsibility of micro-entrepreneurs entail a monetary cost as well as compliance with a series of regulations that render this enfranchising step towards formality a difficult one. This process could be simplified by conferring legal status to the entrepreneur along with the business license¹².

4.2 Labor Rights in Informal Enterprises

Labor law does not fully apply to a significant proportion of workers in the informal sector and a few productive units are able to meet the obligations arising from the establishment of an employment relationship.

The share of workers without a contract or on atypical contracts is over 90 percent in Bolivia and Guatemala, and reaches about 85 percent in Mexico and Ecuador. Pension coverage extends to only 18 percent of those occupied in the informal sector, compared with 68 percent in the formal sector (Tokman, 2006). This difference is partly explained by the poor pension coverage of own account workers. Although the difference between wage-employees is smaller, the coverage of those in micro-enterprises is still one third of those in larger enterprises (CEPAL, 2007). Most workers in the informal sector are not entitled to employment protection because their employment relationship is not legally recognized. On average for Latin America, 78 per cent of wage workers in micro enterprises do not have a written labor contract¹³.

In addition, micro-enterprises are less able to absorb the costs of employing their workers on a formal basis than other firms. In Colombia, a survey of micro-enterprises showed that only 15 per cent of them paid any contribution and that 76 percent could not pay total labor costs. Sales would have to double to absorb these obligations (Gomez, 1998). In Peru, apparently only 15 percent of micro-enterprises were in a position to absorb all labor costs. To do so their profits would decrease between 50 and 100 percent. More than half of the micro-enterprises paid no non-wage labor costs at all and 49.5 percent complied only partly with some obligations (Yañez, 1998).

Recognition of the employment relationship would contribute to improve labor and social protection. This could be achieved with proof of the existence of unwritten contracts by registration of regular hours and periodic wage payments in the accounts or by witnesses. Recognizing the existence of a formal employment relationship generates the pressure needed to manage the production unit according to proper business and not as a family enterprise. This first step will, however, not be sufficient because of the enterprises' inability to absorb the costs of compliance. Some adjustment to the existing legislation may be necessary, but this should not be by deregulation, as being more responsive to the need of micro-enterprises does not mean that existing labor conditions can be allowed to deteriorate.

Alternatives, systems especially designed for the informal sector could be introduced. This would imply dual or preferential systems, as practiced in various countries, such as Argentina, Brazil and Peru. Such differentiation

¹² Fuentes (1998).

¹³ This is for 11 countries but in 6 of these this percentage is higher than 90 percent (CEPAL, 2007).

proves difficult to implement however for regulatory inefficiency reasons and as a matter of principle: it creates opportunities for fiscal and labor law evasion and creates barriers to micro-enterprise growth by setting maximum limits on capital investment. In the area of labor law, such differentiation introduces issues of principles because it accepts differential treatment of workers before the law, depending on the size of the enterprise employing them. For this reason, a single regulatory system is preferable as regards to labor aspects (ILO, 1991).

While introducing a compulsory minimum threshold on labor issues, attention needs to be paid to the financial capacity prevailing in most micro-enterprises. An initial move in that direction was with the introduction of the fundamental labor rights included in the ILO Declaration of 1998 (freedom of association and collective bargaining, elimination of force and child labor and discrimination in respect to employment and occupation). In addition, related aspects of working conditions could also be included, as for example: minimum wage, hours of work and work-related accidents and illnesses¹⁴.

This minimum floor approach should be enforced for all workers in the informal sector independently of the size or form of the unit in which they work. This is not at odds with the notion of operating with a tolerance margin, which allows for the constraints encountered by informal sector production units. This tolerance could be acceptable but should not be applied to fundamental rights or the suggested minimum floor. The application of these rights should be monitored, promoted and controlled using procedures that take full account of the specific nature of each issue being regulated.

Introducing a minimum threshold does not mean accepting that workers in the informal sector have access to only some of the rights enshrined in existing labor laws. On the contrary, the proposal is to recognize the need to make progress in the labor sphere by improving informal-sector enterprises' ability to comply and committing them to follow this path. At the same time, it is recognized that such transition needs time and that there must be complementary policy measures, such as to guarantee access to social protection.

4.3 Insecurity, Vulnerability and Atypical Employment Contracts

Insecurity and vulnerability are linked to the absence of legally recognized employment relations. Insecurity and vulnerability are also present in situations governed by contracts other than the permanent employment contract. This must be distinguished from the situation of workers whose employment relationships are ill-defined or not properly recognized by the labor legislation.

Both aforementioned problems have increased in recent decades as a form of adaptation to the new economic conditions under globalization. Decentralization of production and labor processes emerged as an instrument to decrease costs, particularly labor costs, as well as to increase efficiency given the availability of new technology and the explosive introduction of information technology. This happened both within and between countries as illustrated by the expansion of multinational investment flows worldwide. This contributed to a spurious decentralization to erode compliance with labor regulations or even, diluting the employment relation definition.

¹⁴ This broader minimum threshold has been incorporated into the free trade agreements signed by the United States and various countries, including Mexico, Chile, all the countries of Central America and Dominican Republic, Panama, Peru and Colombia (the latter two still pending of definitive adoption).

At the same time, there was a need to adapt to a more open and volatile international economic environment. Adjustments were needed and the search of flexibility to diminish the costs involved became a priority. Labor reforms introduced alternative contracts to the permanent employment with this objective. Following a strategy of “flexibilization at the margin” atypical contracts for new hirings and reducing dismissal costs were promoted. Employment relationships without contracts are concentrated in the informal sector, while those atypical contracts tend to concentrate in formal enterprises and even in the public sector, but given their association to insecurity they are in the informal economy.

Although the new forms of contract may entail some loss of protection, their chief effect is insecurity about the continuity of the current contract. This insecurity affects the worker and the family as well as productivity, because of the loss of incentives to innovate and to upgrade skills. For this reason, while recognizing that these contracts can contribute to promote employment for women and the youth, limits should be introduced and efforts should focus to making long-term contracts more flexible.

Spain, a pioneer country in 1981, and Argentina in 1991 and 1995 introduced labor reforms searching for flexibility at the margin. The former introduced twelve modalities of special contracts that involved a reduction in firing costs and in the contributions to social security during the first two years focused on those below 30 years old and those above 45, on the long term unemployed and on those with disabilities. The latter followed the same orientation in the reforms mentioned creating a fixed-term contract for multiple purposes: new activities, registered unemployed, apprenticeships and training, among others. All of them contained partial or total exemptions of employer contributions to social security. In 1995 the application of these contracts was extended to old people and women, the trial period increased from 3 to 6 months and indemnities in case of firing were eliminated.

Both countries however, changed the orientation of their reforms since the mid 1990s. Spain restricted the use of fixed term contracts to collective bargaining and transferred the search of flexibility to the permanent contract facilitating the judicial process of firing and reducing the costs involved. This reform was introduced as a result of a Tripartite Agreement. A new Agreement was reached in 2006 reinforcing the new orientation promoting the return to the permanent contract by converting fixed term contracts into permanent contracts after 24 months of a contract with the same enterprise or successive contracts in the same post. It introduced additionally a 4 years bonus for long term contracts given to women, young people and long duration unemployed and reduced contributions to social security.

Argentina followed the same path in its 1998 and 2000 reforms as it constrained the use of fixed term contracts, reduced indemnities in permanent contracts and extended the trial periods. In addition, contributions to social security were reduced in contracts for workers older than 45 years, younger than 24 years and women head of households. In its reform of 1998, Brazil also introduced atypical contracts but made them conditional upon the creation of new jobs (to reduce the potential contract substitution) and left it up to collective bargaining to set upper limits on the number of contracts to be concluded.

4.4 Ill-defined Employment Relationships and their Regulation

Ill-defined employment relationships that are difficult to establish clearly or are disguised or unprotected owing to gaps in the labor regulation or compliance control also need to be re-examined. Rights and obligations of both parties are often unclear and may result in loss of the protection due to workers. Such cases are growing in the context of globalization and decentralization of production. There is a need to ensure workers rights and to identify who is the responsible employer. Most of the enterprises involved in these relations are formal, but as

workers rights in subordinated firms are not usually fully complied to, they are part of the informal economy. These hidden or ill-defined relations also exist between formal and informal units adding difficulties in its identification.

The ILO adopted an Employment Relationship Recommendation in 2006 (No 198). Countries were recommended to “formulate and apply a national policy for clarifying and adapting the scope of relevant laws and regulations, in order to guarantee effective protection for workers who perform work in the context of an employment relationship”.

It is also recommended that national policy should provide guidance for the effective determination of the existence of an employment relationship and on the distinction between employed (subordinate) and self-employed (own account) workers. The Recommendation also suggests that national policies should include measures to combat disguised employment relationships. It should also uphold standards applicable to all forms of contractual arrangements, including those involving multiple parties and ensure that such standards establish who is responsible for the protection contained herein.

The ILO has also addressed the issue of home work and in 1996 adopted both a Convention and a Recommendation which contributed to the formulation of a legal framework. Home-work is a long established form of production which, in appearance, is work performed on own account or within a family structure. However, it often amounts to paid subordinate work performed outside the main enterprise but for the benefit of a subcontracting enterprise or for an intermediary. Such work is performed largely by women, with help of family members and is not taken into account by labor legislation. The absence of a recognized employment relationship leaves the workers vulnerable and without negotiating power. The Convention (No 177) makes a national policy objective to promote equal treatment between home workers and other wage earners, taking into account the special characteristics of home work. This relates to the right of home workers to establish or join organizations of their own choosing and to take part in activities thereof (freedom of association), to protection against discrimination, the minimum age for admission to work employment, remuneration, protection in the field of occupational safety and health, social security and maternity protection.

In this connection, mention may be made of the adoption of a law of subcontracting in Chile where 50 per cent of the enterprises were estimated to contract out part of their production and 20.7 percent to subcontract their main economic activity in 2004. Moreover, one third of the labor was estimated not to have a direct contractual link with their employing enterprise, but to be providing services via subcontractors or through agencies supplying temporary staff. The law sets limits only on the supply of staff for short-term jobs and exceptional tasks. In order to comply with labor law obligations, it requires enterprises to register and establish a guarantee fund to meet wage costs and contributions in case of non-compliance. Regarding the subcontracted the responsibility lies with the subcontractor, but the law also places responsibilities on the main firm. The law changes the existing subsidiary's responsibility of the main firm into a jointly responsible compliance with these obligations. However, the main enterprise may exercise its right to require certification of compliance by the subcontractor and may withhold from pending payments any amounts due in case of non-compliance. While recognizing that this subcontracting model has the advantage of being more flexible than other production models, the law requires a proof of compliance from the enforcement authority involved and makes the main enterprise an indirect agent of control to ensure that the subcontractor complies with his/her obligations under labor law.

4.5 Social Protection for Informal Workers

Coverage extension of social protection for informal workers requires a strategy that considers different options, from expanding coverage of existing systems to the development of new mechanisms by the excluded through pooling of resources or insurances. All alternatives can be considered, while examples of different schemes for the provision of protection need to be evaluated.

From a systemic perspective these rights should be granted to the people as citizens rather than as workers and awarded on universality principles. This has been the major change in the redesigning of the “traditional model” in Latin America as well as to complete the private defined contribution pension systems adding a solidarity pillar funded from public resources. The World Bank, in its recently published report on informality (2007), fully supports this change both for the case of health and pensions coverage. In the case of health care, it is recognized that as shocks that go uncovered impose significant costs to society, there is a case for providing minimum essential direct cover, de-linked from the labor contract and financed through general taxation. Similarly, in the case of old age insufficient incomes, there are social costs involved that justify a minimum income support not associated to the labor contract.

Bolivia is the only country in Latin America that introduced a universal non-contributory pension (BONOSOL) and Brazil has a similar system for rural workers (FUNRURAL)¹⁵.

Chile, a pioneer country in introducing the privatization of the pension and health systems, is taking the lead introducing a non-contributory pillar that guarantees a solidarity pension to all citizens after 65 years old perceiving a pension of less than 150% the minimum wage. It will be universally granted, but efficiency is ensured by gradually reducing the subsidy for those who perceive other pensions, thus reducing the need for public funds and providing incentives to contribute to the system. In fact, the resulting model establishes a mid-way for non-contributory pensions, since it is universal for all citizens, but it recovers partly the fiscal contribution from the high income pensioners.

Health is covered to a larger extent than pensions and reaches universality by a combination of different systems: a social insurance in Costa Rica that covers contributors and non-contributors, a public funded system in Cuba and a mix of public institutions, social security and private insurances in Uruguay, Brazil and Chile, among others. The latter has strengthened access to public health for all citizens by introducing an attention guarantee of 56 basic pathologies (AUGE) in addition to the existing national health insurance (FONASA).

De-linking protection from labor insertion would create opportunities to increase employment and improve businesses, while guaranteeing security. It will contribute to decrease the existing protection deficits but it will require sound fiscal policies and particularly, the adequate funding of decent health and pensions coverage. It should also include maternity and child care, given its potential effect on the early development of cognitive abilities and on the participation of women, particularly those from poor households, in the labor market.

¹⁵ The public funds involved are the highest in Bolivia (1.2% of GNP) and are estimated for the quasi-universal pension of Chile at 1%, compared to the focused pensions in the Region that are usually below 0.5% of GNP.

5. A Different View on Formalization: from Informality to Economic Citizenship

Previously discussed options lead to a different vision of formalization as a tool to ease the integration of informal activities in the modernization process. The extension of formalization is not warranted from the point of view of the organized sectors, but rather articulated around the benefits that access to formality may bring about to foster the development of informal activities and the people occupied in this economic sector.

For instance, oversight campaigns targeting informal activities are often justified by the need to widen the tax base, cut down evasion and punish illegality. While these are important objectives *per se*, it is also well known that these campaigns usually do not yield the expected results. Actually, the importance of the integration of an informal activity as a tax paying entity is that its first consequence consists in meeting a basic business requirement, such as producing accounting information. If the entrepreneur fails to do so s/he is deprived of a key tool of modern management, a requirement to achieve full economic citizenship.

The same thing happens with the recognition of labour contracts, an area where the goal should not be so much to punish illegality, as to create citizens who are ready as workers to gain access to labour protection, or embrace the logic of business, as would be the case of the micro-entrepreneurs who have to adapt to formal labour relationships. Having to respect certain labour rules is conducive to more modern management standards.

Micro-enterprises present a paradox. Large enterprises are shifting strategies to improve competitiveness and increase productivity, by adopting more flexible productive systems to smooth supply-side fluctuations; by producing goods upon request, and by getting closer to customers before and after delivering the goods. This is the kind of approach traditionally followed by small businesses. A new opportunity is opening up. Yet, to take advantage of it, micro-entrepreneurs must radically alter their behaviour by going through a process of cultural change. They must move from individualistic ways of doing business, driven by the imperative of succeeding by any means in a wild competitive environment, to a culture that seeks the benefits of pooling productive resources as well as associating with other producers in their efforts to gain access to the marketplace.

Previous ways of relating to customers should change too, and new forms of communicating with different actors should be explored. From working on an individual basis and being barred from credit in an environment in which s/he usually entertains a personal relationship with customers, the entrepreneur must start producing for a market in which customers are faceless, request good quality, expect timely services and expect professionalism. The informal sector operates in flexible ways but it is culturally unprepared to produce for demanding markets

In order to have access to credit, informal micro-entrepreneurs must undergo a cultural change that involves establishing and nurturing relationships within the banking system. Likewise, dealing with state institutions requires learning to take advantage of existing programs designed to assist entrepreneurs, as well as not letting themselves be intimidated by ministerial and other public authorities. They must also get acquainted with the ways and means of collective representation, when securing benefits and concessions is the result of social efforts. Usually, micro-entrepreneurs or their workers do not join business or trade union organizations. After all, it was not so long ago that these organizations stopped seeing them both as disloyal competitors, and started to make efforts to integrate them and accommodate their concerns, mainly as a result of a quest for greater representation. The same happens with those workers that incorporated to the informal economy but work directly or indirectly with formal enterprises. New regulations to incorporate this situation, starting perhaps

by the recognition of the existence of a labour relation as well as the exercise of the right of voice and organization will contribute to empower them to become the main actors of their own improvement.

The present proposal is indeed addressed to the ongoing cultural change. It seeks to foster new attitudes and behaviour to favour the development of the micro-enterprises and of those who labour in informal economy in an environment more conducive to success. Formalization may be the gateway to full economic citizenship as a prerequisite to competition in the marketplace. It entails rights as well as duties. The proposed views alter previous priorities. Rights should be emphasized over duties, because the former are tools for development and progress. Enfranchisement may inspire “virtuous circles” leading to the expansion of the regulatory framework and to the creation of new conditions to allow citizens to comply with their duties, while also benefiting from them. Such a context would provide incentives to turn those in the informal economy into the main force behind formalization efforts.

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