

**DESA Working Paper No. 42**

ST/ESA/2007/DWP/42

June 2007

**Modernizing the informal sector***Victor E. Tokman*

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**Abstract**

The multiplicity of policies proposed to support the informal sector reflects the lack of a common definition. Although they may produce positive effects, these are limited and fail to constitute a comprehensive strategic approach. The different interpretations in the absence of a common definition as well as the strategies emerging from them are reviewed. The identification of informality with illegality and labour precariousness, although conceptually related, is often misleading. Lastly, it explores a strategic option to regulate the informal sector, tracing the different approaches to formalizing informal activities, to facilitate their full integration into the modernization process.

JEL Classification: O17; J48; D39

Keywords: informal sector, regulation and informality

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# Modernizing the informal sector

*Victor E. Tokman*<sup>1</sup>

There is general agreement over the need to pay attention to the informal sector because of its importance to employment and poverty issues. There are also an increasing number of programmes aimed at supporting similar informal activities in highly diverse national contexts. This consensus is backed through the adoption, at the highest level, of policy measures that are meeting with growing acceptance and, sometimes, the active support of social actors, in particular among entrepreneurial and trade union organizations. Such a stand is also based on evidence to the effect that policies to promote the informal sector are viable and profitable, even during economic downswings, and have international financial support.

Nevertheless, to the extent that it fails to embrace a shared strategic vision, this is a limited consensus that hinders the effectiveness of policies implemented in this area. While often adequate on an individual basis, they are insufficient and produce limited effects by failing to respond to a more comprehensive approach.

The lack of a shared approach is related to the absence of a common definition of the informal sector, which has grown increasingly complex since it was first described in a pioneering ILO report on Kenya in 1972. Along with the heterogeneous nature of informal economic activities, different perceptions lead to different strategies. These are reviewed in the first section. Too great an emphasis on the regulatory perspective has identified informality with illegality and labour precariousness. In spite of their ties to informality, however, the two categories are conceptually different. The second section is devoted to these subjects and, particularly, to the precariousness of the employment relationship. Lastly, the third section explores strategic options to regulate the informal sector, tracing the features of a different approach to formalizing informal activities, to facilitate their full integration in the modernization process. For the purpose of this paper, the latter concept is defined as the most dynamic part of the economy operating under a common regulatory framework.

## Facts and concepts

### *Interpretations and trends*

The notion of the informal sector was brought forward in a 1972 ILO report on Kenya (ILO, 1972), following a 1971 paper (Hart, 1973). They highlighted that the problem of employment in less-developed countries is not one of unemployment but rather of employed workers who do not earn enough money to make a living. They are 'working poor'. This conceptual interpretation was based on their opposition to formality and their lack of access to the market and productive resources.

This was followed by several contributions (see Tokman, 1978). One perspective is guided by the logic of survival. Informal sector activities are the result of pressure exerted by a labour surplus for jobs, when good jobs, usually in the modern sectors, are scarce. The result is that people seek low-productivity, low-income solutions by producing or selling anything that may provide for their survival.

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<sup>1</sup> This paper builds on several earlier papers (Tokman, 2001a and 2001b). It updates the conceptual discussion and facts about informality.

Another rationale associated with globalization and changes in the international division of labour, points to productive decentralization (Portes, Castells and Benton, 1989). To deal with an increasingly unstable demand, modern enterprises adapt to the new environment by introducing more flexible productive systems and decentralizing productive and labour processes, which allow them to cut production costs and to externalize demand fluctuation.

Other research efforts attach growing importance to the informal sector's operation beyond the prevailing legal and institutional frameworks (de Soto, 1986). However, the issue of whether this feature is the cause or the consequence of informal activities has not yet been settled. An even more recent evolution in the concept placing the emphasis on the employment relationship has led the ILO (2002) to extend informality from the sector to the overall economy.

Efforts to explain the informal sector have shifted focus throughout the years. The logic of survival has also been, and continues to be, a major factor in the development of informal activities. There is a growing presence of new activities generated by the logic of decentralization, particularly in a context of rapid economic opening, and the extra-regulatory behaviour has become an important aspect for analysis and policy. The increase in precarious labour, partly promoted by labour reforms, is also a major factor in the ongoing discussion.

Independent of the interpretation adopted, the characteristics of the informal sector are similar: small, unsophisticated technologies, low capital requirements per worker, and a distinction between micro- and large-sized enterprises in terms of capital requirements. Additional features include limited sharing of the property of the means of production, and a majority of waged workers labouring without contracts and protection.

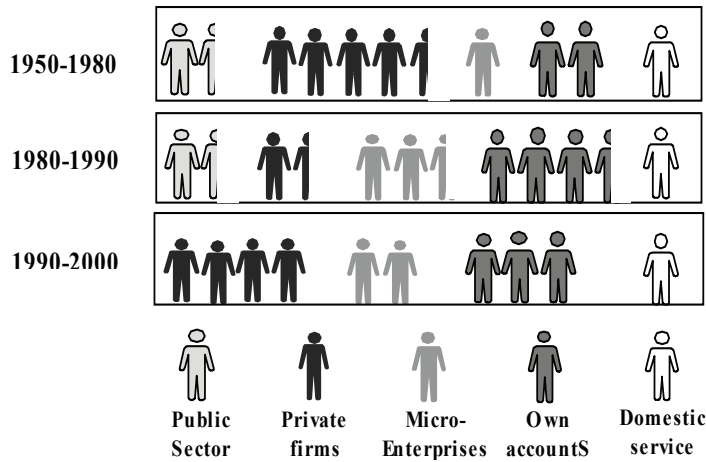
The importance of the informal sector as a source of new jobs is unmistakable. By 2003, this sector was providing about half of total urban employment<sup>2</sup>. Moreover, its share in the labour market continued to grow steadily. Out of every 100 new jobs created since 1980, around 60 have been informal ones. The current process of growing informality is undergoing a transformation in that micro-enterprises are showing the highest rate of growth. An increasing number of these enterprises are becoming a valid job-creation option regarding income, although they are still far from offering acceptable conditions in terms of job stability and labour and social protections.

The growing importance of informality in the 1980s is clear and marks a break with the three preceding decades. Between 1950 and 1980, approximately four out of every ten new jobs were created by the informal sector; i.e. the equivalent of two thirds of its contribution during the adjustment. This behaviour was determined by two factors: the withdrawal of the public sector as a net employer, and downsizing measures implemented by large-sized enterprises. The public sector conducted its own adjustment process, as part of policies aimed at reducing the fiscal deficit and promoting privatization. Meanwhile, large-sized enterprises dealt with the economic opening by increasing productivity, basically at the expense of employment. Public employment decreased in relative and, in some countries, even in absolute terms. During the 1990s there was some recovery, but only 15 out of every 100 new jobs were generated by large-sized enterprises, that is, one third of their contribution before the adjustment process. In fact, the rapidly expanding

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2 The informal sector is defined as including the self-employed with less than 13 years of education, unpaid family members, employees and employers in establishments of less than five employees and domestic servants (Tokman, 2004).

Figure 1.  
**Latin America: Employment generation by sector, 1950-2000**  
 (Origin by sector of each 10 new jobs)



Source: Tokman, V.E. (2001b).

of modernization that to varying degrees is currently underway in Latin America; this is an alternative way of designing a survival support strategy, conceived as a policy to fight poverty with a welfare bias. While the informal sector embraces survival activities that have no chance of converging with the mainstream of a country's economy, it also includes a large number of activities whose growth is dependent on the ability to incorporate them fully into the overall economic system.

This important objective would help to turn support for the informal sector into a source of self-sustained growth behaviour no longer tied to permanent governmental support. On the other hand, an equally important objective such as poverty alleviation through the support of survival strategies that do not promote income expansion tends to perpetuate inequality and segmentation. Emphasis should, therefore, be placed on moving towards integration. By doing so, the orientation of a variety of institutions created to support informal activities could also be clarified. Presently, these agencies are torn between welfare interventions and productive initiatives that often lead to conflicting actions and, worse yet, inter-agency strife.

Integration of the informal sector into the process of modernization may be achieved through different but complementary means. Prevailing policies to this effect generally favour a three-pronged approach. The first consists of providing support to foster the productive development of micro-enterprises by facilitating their access to market and productive resources. The tools used more frequently for those purposes are credit programmes, as well as training and promotional programmes to seek access to more dynamic markets by strengthening organizational skills and marketing practices.

The second approach involves the social welfare of informal workers. At this level, policy options tend to get mixed with poverty-alleviation policies. It should be kept in mind, however, that the family unit and the small-scale productive unit always become entangled. Labour and family relations merge in a workshop or small business. Capital goods, such as means of transport, are investment capital, to the extent that they are used for business purposes. However, they are also consumer goods used for private purposes, which renders them family assets too. Resource fungibility makes the absence of social protection an obstacle to good economic performance. In other words, when the uninsured owner-worker gets sick the micro-enter-

segment of micro-enterprises arose from the need to provide the jobs that large-sized enterprises failed to create (Figure1).

In addition, subcontracting and decentralization of production and work processes to reduce costs contributed to the enlargement of the informal sector at the expense of labour protection.

*Alternative strategies*

The interpretations discussed above suggest different strategic courses of action. The main approach of this paper is to seek ways and means to incorporate the informal sector into the process

prise collapses. Thus, mutually complementing policies implemented from a social welfare perspective have externalities capable of generating a positive interaction with the productive development of the poor.

Lastly, a third course of action focuses on the regulatory framework. Informal activities are not caused by regulatory inadequacies but rather by the failure of the economic system to create enough productive employment. However, the fact that regulatory improvements favour the integration of informal activities into the modernization process cannot be ignored. This debate has evolved in the last few years, resulting in a substantial narrowing of the gap which had existed between those who argued in favour of the simplistic notion that legislative or procedural changes are enough to overcome the existing problems and those who denied the role of regulatory arrangements relating to the economic system.

While recognizing the relevance of the first two courses of action discussed above, this paper addresses the latter. It attempts to deepen a strategy aimed at altering the regulatory framework in a manner conducive to the integration of the informal sector.

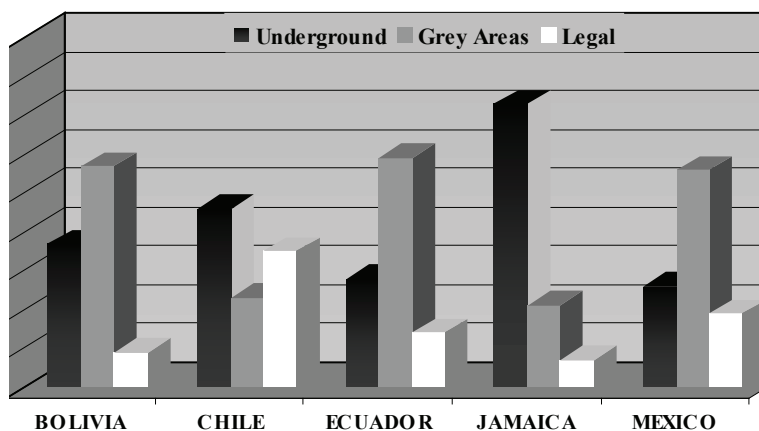
## Formalization as a means of inclusion

### *Informality and illegality*

A generally accepted interpretation of the genesis of informal activities is rooted in their operating beyond the prevailing regulatory systems. In other words, these activities do not comply with legal or administrative requirements. A more positive view suggests that exclusion has to do with the lack of access to development policies, in particular to credit programmes, training and the marketplace. This approach to the informal sector emphasizes lawlessness as a feature and tends to deal with it as an area devoted to underground activities.

Actual conditions in the marketplace are not as unequivocal as it would appear. The informal sector is not a 'black market' operation, and the modern sector is not as law-abiding as could be expected—grey areas prevail, as it were. Informal activities were previously described as the result of limited compliance with legal and procedural requirements, going from complete illegality to full compliance (Tokman, 1992; Tokman and Klein, 1996). What prevails, however, is a middle ground where certain registration prerequisites are met, while tax obligations are neglected and haphazard compliance with labour law is commonplace. This situation is also found in modern activities, particularly in countries where fiscal discipline is poor and inspection capabilities are limited. Obviously, total illegality is non-existent, but limited legality is significant.

Figure 2.  
**Informality and illegality**  
(per cent of informal units by levels of illegality)



Source: Tokman V.E. and Klein, E. (1996) and Tokman V.E. (1992).

On the other hand, data on the informal sector around 1997 show that micro-enterprises making limited contributions to finance labour benefits reached 65 per cent in Peru (only 6.4 per cent was in full compliance, while 28.6

per cent failed to make any payments), 70 per cent in Brazil and 57 per cent in Chile (Tokman, 2001b). The proportion of micro-enterprises that paid some taxes is significantly higher: 94 per cent in Peru in 1996; in Chile, where some 70 per cent of the micro-enterprises employing five or less workers, and 96 per cent of those employing five or more workers, paid income tax and value added tax (VAT) in 1990; in Ecuador, where 78 per cent of small micro-enterprises and 94 per cent of larger micro-enterprises paid income tax, while 54 per cent and 81 per cent respectively paid VAT. Moreover, close to 80 per cent of Ecuadorian micro-enterprises paid some municipal taxes. However, a significant proportion of the micro-enterprises operating in all these countries, and a majority in some of them, failed to comply fully with labour and tax laws.

ILO research also confirmed the high cost of formality. To bring a micro-enterprise in line with regulations, micro-entrepreneurs must go through a number of different administrative procedures: at least 11 are required in Brazil, nine in Peru, six in Colombia, and four in Chile. Obviously, each of these procedures, such as applying for a licence to start a business or requesting sanitary clearance, entails a large amount of paperwork and bureaucracy. In addition, micro-entrepreneurs must pay at least 10 different taxes and social insurance contributions in Brazil, seven in Colombia and eight in Peru. The number of procedures involved and weekdays devoted to them varies from country to country, depending on the number of regulations, the competence of the bureaucratic system and the nature of the country's administrative and institutional organization.

Given this heterogeneity of relationships to the regulation system, informality cannot be defined solely by this variable. Structural features related to the existence of surplus labour, production and work organization and market structures are more important determinants of the existence of informal activities than access costs to legality. However, they result in a certain degree of illegality.

### ***Informality and labour precariousness***

Labour relations have become more precarious since the mid-1980s. This results not only from a transformation in the employment structure, but also from the introduction of labour reforms in search of more flexible employment relationships, to gain the competitiveness required to operate in a more open national and world economy. They were geared to gain efficiency, without taking due account of the costs involved in terms of the effects on labour and social protection. These reforms constituted a second generation in the economic reforms package. They were justified by a diagnosis of the existence of too much rigidity in the labour market. In addition, a decentralization process resulted in increased interrelationships between enterprises of different sizes.

The main modality adopted by the labour reforms was the introduction of atypical labour contracts of a different nature, but possessing more flexibility than the indefinite-term contract with full protection that constituted the predominant contract. This was consistent with the objective of job stability. Promotional labour contracts of different sorts were introduced, such as fixed-term, temporary and part-time contracts, as well as contracts specifically tailored to youths, women and unemployed head of households, among others. In some cases, like Peru, in addition to the introduction of these new contracts, the externalization of the labour process was promoted by allowing the creation of workers' cooperatives or 'services' to supply labour to enterprises. These new contractual forms provide less stability and allow for employment adjustments by firings in an easier and less costly manner in relation to the previous contracts. In some cases, though not in the majority, the atypical contracts are exempted, partially or entirely, from honouring some labour obligations.



The scarce and fragmented data available shows the importance and expansion of workers under atypical contracts and those without any contract. The growth of these contracts is clear during the first half of the 1990s and, although the data is not entirely comparable, it shows that the process continued in Peru, where workers without contracts or with atypical contracts reached 74 per cent by 2000, and in Chile, where the percentage reached 45 per cent. By 2002, on average for 11 countries with information from household surveys, workers without contracts amounted to 47 per cent, while those with contracts that are not for an indefinite term reached 21 per cent, (Tokman, 2006).

The legal and explicit recognition of the employment relationship is crucial because it constitutes a prerequisite for the recognition of the rights to labour and social protection. Recent data on coverage of pensions show that workers with written contracts are covered six times more than those without contracts. Furthermore, waged workers in micro-enterprises moving to a formal enterprise of larger size increase their probability of being covered by pensions from 24 to 66 per cent (Tokman, 2006).

The result has been that, together with labour contracts diversification, there has been an increase in workers without any contract. The latter situation does not recognize any legal obligation, while the former, in some cases, diminishes or dilutes the level of obligation but maintains its legality. This is partly the consequence of the failures in labour legislation to adapt to new forms adopted by the labour relationship, and partly because of the weakness of labour inspection in most countries. It could also be the reading of employers of the signs of flexibility associated with the labour reform discourse, which had underlined the rigidities, accompanied by permissiveness of inspection in a weak labour institutional environment. Beyond flexibilization, the discourse and the reforms transmitted a message, willingly or not, of deregulation.

Thus, undeclared and precarious work, usually associated with informality, builds up in the labour market. Informality, illegality and precariousness have become synonymous. Unprotected and precarious labour is not only found in the informal sector but also in formal enterprises or in production chains, introduced to reduce costs and gain flexibility. This led the ILO to widen the informal sector concept, introduced at the beginning of the 1970s, incorporating a new concept: the informal economy. The latter includes the informal sector, but adds all the workers occupied, directly or indirectly, by formal enterprises.

The International Conference on Labour Statistics held in 1991 agreed to define the informal sector to identify its contribution to the GNP, usually omitted from national accounts. It was agreed that the sector should be defined according to the characteristics of the productive units that perform these activities (entrepreneurial approach), rather than by the characteristics of the persons involved or their occupational position (labour approach). This was consistent with the concept of the informal sector introduced by the ILO in 1972. The new concept, as approved by the International Labour Conference in 2002 (ILO, 2002)—considering that the former approach does not capture all dimensions of informal employment—recommends that workers should be classified as formal or informal according to their labour status. It does not propose to eliminate the concept of the informal sector but rather to extend it to the informal economy.

In this connection, work posts were selected as the unit of analysis and added to the unit of production previously considered informal. The main innovation is the inclusion as informal of all workers, independently of where they work, whose employment relationship is not subject to labour legislation standards, taxes, social protection and other labour benefits (vacations, sick leave, firing indemnity, etc.). This mostly means the addition to the informal sector of all unprotected labour working in enterprises of more than five workers. Statistically, the urban informal economy implied an expansion of the informal sector from 46 to



57 per cent in Mexico and from 31 to 36 per cent in Chile, around 2003.<sup>3</sup>

The use of atypical contractual arrangements in formal enterprises is a regular practice and results in a reduction of labour protection. This trend does not necessarily denote informality, however, but rather the application of new labour laws or ambiguous labour legislation, or simply law evasion. The loss of protection since the 1990s can be significant, as suggested by differences in pensions coverage: in 2002, 86 per cent of workers with indefinite term contracts were covered, compared to only 57 per cent of those under other types of contracts (Tokman, 2006).

The ILO, consistent with the recognition of a significant and increasing use of unprotected labour, has promoted the adoption of new international labour instruments (conventions and recommendations) aiming at protecting working rights. A proposal for a new labour standard failed to pass in 1998, and ILO was asked to analyze in depth the nature of the employment relationships. The process finished at the recent International Labour Conference held in June 2006, with a recommendation that advises governments to “effectively establish the existence of an employment relationship”, to “combat disguised employment relationships”, “to ensure standards applicable to all forms of contractual arrangements including those involving multiple parties” and “to establish who is responsible for the protection contained”. The adopted recommendation did not receive, however, the full support of the ILO constituency, denoting that the substantive discussion about the potential existence of trade-offs between employment and protection is not yet settled.<sup>4</sup>

While the effort made to advance the clarification of the employment relationship aiming at a review of the labour regulations to ensure protection should be appreciated, its contribution to dealing with informality is not obvious. A first conceptual observation refers to the combination of two units of analysis, unit of production and work post, and their relationship with access to labour and social protection. In fact, the latter is made in a partial manner since those working in the informal sector are, by default, considered as unprotected labour. This does not reflect the prevailing situation as informality cannot be taken as synonymous with unprotected labour because some workers in the informal sector do have access to protection. In 2002, 35.6 per cent of those persons occupied in the informal sector had coverage for old age pensions. There are differences within them as only 6 per cent of the self-employed are covered, compared to 24 per cent of workers in micro-enterprises.<sup>5</sup>

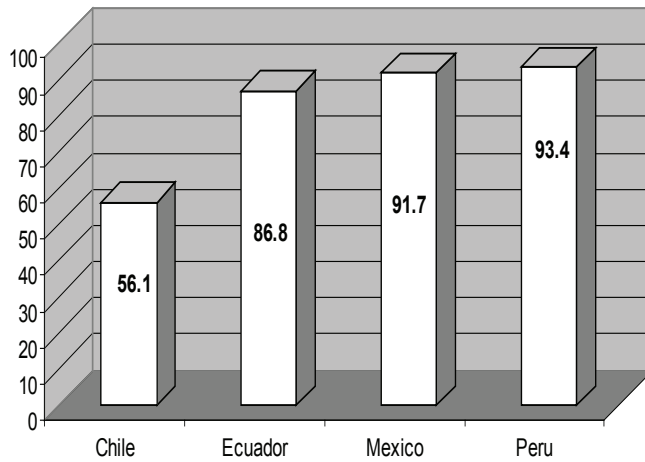
However, for the majority of those employed in the informal sector the lack of access to labour and social protections is the result of the informal nature of small-scale economic activities. Only in micro-enterprises do these concepts tend to represent a single phenomenon of informality. As can be seen in Figure 3, more than 90 per cent of workers in micro-enterprises in Mexico and Peru are without written contracts, or

3 This estimate refers only to the urban informal economy. If informality in rural areas is included, as suggested by the ILO in 2002, the increase is from 57 to 65 per cent in Mexico.

4 The employers in the ILO, on the basis of the need for further analysis on the subject in 1998, obtained a postponement and the commitment of the secretariat to undertake further studies and to resubmit it in 2003 for a general discussion. However, in 2006, they still voted against the adoption of the recommendation on this subject.

5 A special case in the differentiation of the informal economy and sector are home workers, mostly women, who are included in the informal sector because of their unit of production characteristics. But if their work results in a product or service as specified by the employer, and unless this person has the degree of autonomy and economic independence necessary, it should be considered as a decentralized labour relationship and treated similarly to other wage earners, taking into account the special characteristics of home work. This entitles them to the right of association in an organization of their own choosing and of labour protection. The responsibility for complying with this obligation should be shared between employers and intermediaries, if they exist. The situation of home workers is guided by the ILO Convention 177 of 1996. Unfortunately, up to 2005, only four countries have ratified this Convention (Albania, Finland, Ireland and Netherlands).

Figure 3.  
Precarious and undeclared labour in micro-enterprises



Source: Tokman V.E. and Martinez, D. (1999).

are in precarious contracts; the percentage is 87 per cent in Ecuador; and, even in a more formalized country like Chile, it reaches 56 per cent. The concentration of self-employment, undeclared and precarious labour in the informal sector results in lower protection. Only 18 per cent of those employed are covered by social security, compared to 68 per cent of coverage in the formal sector.

The starting point for integration into the regulatory system is the inability of informal entrepreneurs to comply with the requirements and to shoulder the cost involved in becoming formal. A study conducted in Peru (Tokman, 2001b) estimated that only 35 per cent of the micro-enterprises employing five or less workers and 60 per cent of those employing between six and ten workers could comply with the whole package of social insurance contributions. It was also estimated that full compliance would represent over a 50 per cent cut in the profits of 75 per cent of these enterprises. The proportion of compliant micro-enterprises would significantly drop under 35 per cent, however, if the burden of complying with income and other taxes were to be added. For this group the trade-off is not only one of employment and protection but rather one of employment and public welfare.

Apart from considering the conceptual differences, it is also important to deepen strategic options to integrate the informal sector into the regulatory system as a means of achieving fuller participation in the modernization process. The starting point is recognition of the inability of informal entrepreneurs to comply with legal requirements and to shoulder the costs of becoming formal. Regardless of the various factors involved, this situation shows an unbalanced relationship between requirements and possibilities, and calls for a different approach if the goal is to advance the formalization process as a tool to achieve integration in the modern sector.

Given the existence of grey areas and segmentation within the informal sector, the question arises as to whether a differentiated set of regulations responding to the specific characteristics and capabilities of this economic sector and its different segments should apply. Before dealing with this issue and undertaking the design of strategic options to regulate informality, the chances of each informal segment accomplishing a successful process of modernization should be assessed.

Available empirical evidence about productivity and income in the segment of productive units that respond to survival strategies shows that they would accomplish very little through productive modernization. Most of them are family units in which regular labour relations have no place, and which operate at such low levels of productivity and income that compliance with administrative regulations and tax laws is hardly feasible. Without neglecting issues such as access to credit and training, and occupational safety and hygiene, the situation of these informal units would be more adequately addressed through anti-poverty interventions. Therefore, strategic options seeking to formalize informality should concentrate their efforts on productive units that show some potential in terms of achieving productive modernization.

## Options to regulate informality

A first option would be to design an ad hoc regulatory system different from existing regulatory schemes that apply to activities and individuals occupied in more organized sectors. This would involve the adoption of dual or preferential regimes. This approach is opposed on fiscal, commercial and, above all, on labour grounds. Distinctions sanctioned by law hamper fiscal oversight both with regard to micro-enterprises and large-sized enterprises, by causing 'sliding' for tax evasion purposes (Revilla, 1999). Furthermore, limitations imbedded in special regimes often become obstacles to the growth of the micro-enterprises involved. In the labour field, the implementation of preferential schemes would entail that, depending on the size of the enterprises, workers would no longer be treated equally before the law. Therefore, for reasons that mainly take into account the labour dimension of this issue, a single system would be preferable, even acknowledging that full compliance with existing legal requirements is impossible, at least during a transition period (ILO, 1991).

It should be emphasized that the preference for single systems has to do with special comprehensive regimes, but it does not exclude the implementation of de facto differential tax procedures, such as a non-taxable basic income, simplified tax declarations or tax estimations based on presumptive income, nor does it exclude either the implementation of credit programmes at preferential interest rates. Even objections raised regarding labour issues depend on the nature of the affected rights. For instance, it is generally acceptable to introduce a distinction in collective bargaining to best address the peculiarities of small productive units.

The single regime proposition also generates a variety of options open to the implementation of different policies. The first one argues that to accept a de facto dual situation without enforcing penalties entails a certain degree of tolerance, as well as the adoption of a different promotional rationale for the informal sector while other economic sectors are being penalized. This is one of the courses of action usually followed in the field of labour rights, where legal requirements become goals and progress towards greater compliance is an area subject to monitoring and oversight. All this should be qualified by the respect due to certain fundamental labour rights whose enforcement is required, regardless of the nature of the activity or labour relationship involved, to the extent that these are labour-related human rights, notably, freedom of association and collective bargaining, forced labour, non-discrimination and eradication of child labour. This option may be described as a "single regime with qualified tolerance and a minimum floor"<sup>6</sup>.

A second, non-exclusionary, strategic option consists in adapting formalization requirements to bring them closer to the capabilities of informal entrepreneurs, insofar as the costs of formality and formalization procedures and machinery are concerned.

The cost of legalizing informal activities may be cut down, without affecting the 'single regime' perspective, provided that the reduction is universal. This is the current stand in the labour field, where the flexibility and reduction of non-salary labour costs sought by the modern sectors to improve competitiveness should also lead to the abatement of obstacles to the integration of informal activities. The same thing may take place in the fiscal area because of reduced taxation or increased emphasis on informal activities. Unlike current trends in the labour area, present tendencies in the fiscal area go in the opposite direction, as expanding tax collection becomes a major priority and taxation increasingly relies on VAT.

6 The recent experience in the negotiations of the Federation of Tax Administrators between several Latin American countries and the United States of America has expanded this minimum floor, contained in the ILO Declaration of 1998, by adding working conditions (minimum wages, health and safety and hours of work) to discipline, including trade sanctions.

Simplifying bureaucratic procedures is another way of bringing down access barriers. Numerous measures have been adopted to implement simplified registration regimes, both in terms of unifying registries and administrative steps towards compliance. Current trends point to the implementation of a single-registry, single-window regime. This approach would minimize the cost of formalization, but its feasibility has not yet been tried. Creating a single authority would facilitate the dissemination of information and avoid overlapping and contradictory regulations, administrative procedures and oversight efforts. However, this field is littered with obstacles, from bureaucratic vested interests to technical demands raised by oversight and enforcement actions. This situation may present the opportunity in some fields of combining interventions by institutions with different objectives to follow a unified procedure. The cost involved for the micro-entrepreneurs would be less than in the present multiple agency inspections.

Lastly, there is room for action regarding the mechanisms for formalization. An increasingly popular device, first suggested by de Soto (1995), is the recognition of property titles as a mechanism to have access to credit. The proposed innovation seeks to simplify the release of a legal property title and to adapt it to prevalent conditions of *de facto* ownership. This course entails disregarding contractual prerequisites and providing proof of property using alternative means of recognition, such as long-term usufruct, calling on witnesses (preferably neighbours when housing or land are involved) and having boundaries recognized by third parties when there are conflicts of interest. Thus, entitlement responds to a major obstacle to having access to credit, since collateral requirements, which usually involve assets, represent a further hurdle to a sector where 'property' is not formalized.

An additional formalization tool, which could be modified for the same purpose, is the recognition of labour relationships. In Peru, for instance, 90 per cent of labour contracts in informal activities are not written, although this is an indispensable prerequisite to have access to the benefits of employment promotion laws. Nevertheless, a verbal contract entered into by mutual agreement could be accepted as an alternative, without having to stretch the existing regulations. A note in the employer's monthly book may provide proof of the labour relationship, by calling witnesses to attest to it or to the performance of a regular work schedule, or by showing proof that salaries have been paid. All of this would help to 'formalize' the labour relationship, as a first step to entering into regulated relations.

Street vendors deserve special treatment through the implementation of a strategy capable of reconciling the public's right to enjoy public spaces and the right of street vendors to have a stable, income-generating occupation. While these activities must be regulated within a single legal, fiscal and labour framework, the relevant formalization and modernization strategy must also take into account the peculiarities of this sector. First, access to land through ownership or leasing, for the purpose of setting up commercial activities in compliance with municipal regulations; secondly, rendering the supply of available urban land compatible with the public transportation system, to provide the public with adequate access to shopping areas; thirdly, encouraging street vendors to organize both at the market level and also at a higher level, to improve the rate of return of their investment by developing economies of scale.

The separation of assets between the individual and the entrepreneur (also a very important step to micro-entrepreneurs), 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 licence (Fuentes, 1997).

## 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; rather, for the benefits that access to formality may bring about to foster the development of informal activities and the people occupied in this economic sector.

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. (According to SUNAT, every additional sol collected in Peru entails an administrative cost of 0.75.) 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 he is deprived of a key tool of modern management, a requirement to achieve full economic citizenship.

The same 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 micro-entrepreneurs who have to adapt to formal labour relationships. Having to respect certain labour rules is conducive to more modern management standards.

A similar argument may be advanced regarding the recognition of ownership titles for the purpose of gaining access to credit or to a patrimonial division between the individual and the business, brought about by receiving the legal right to subscribe contracts. As far as street vendors are concerned, stopping police harassment and assuring a stable and lawful place of business reduces the cost of informality and may also provide access to new markets and productive resources.

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, producing goods upon request and 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 therefore opening up.

To take advantage of it, however, 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 an extremely competitive environment, to a culture that seeks the benefits of pooling productive resources and associating with other producers in an effort 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 he or she 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 programmes designed to assist entrepreneurs, and not being 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 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 them 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 informal businesses into the main force behind formalization efforts.

Lastly, the present strategy faces at least two limitations that it is unlikely to overcome on its own. The first one is represented by a segment of survival activities that would gain very little from formalization. The second is that the effects of formalization will not come automatically and may become insufficient to integrate informal activities into the modernization process. Therefore, complementary measures should be taken to secure the benefits of enfranchisement. Entitlement requires financial institutions to make adjustments to acknowledge the value of property. To have access to safe places of business of their own, street vendors need marketplace support, credit and advice. The recognition of legal status as a corporate, labour and fiscal subject must go along with educational efforts to learn to take advantage of administrative and productivity accounting books, patrimonial division and more formal labour relationships. Special machinery and financing may also be necessary to facilitate the transition period.



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