

Beyond the Invisible:
The Impact of Trade Liberalization and Formalization on Small Businesses in Colombia

A dissertation submitted in partial fulfillment of the requirements for the degree of Doctor of
Philosophy in Public Policy at George Mason University

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DEDICATION

This thesis is dedicated to my wife, Monica, and my daughter, Isabella, for their support of my ideas, their patience in my research endeavors, and their unconditional love, which made all of this possible.

ACKNOWLEDGEMENTS

I would like to thank my dissertation committee members for their patience and invaluable support while I developed and redeveloped this thesis. I would also like to thank all those who took time to discuss these issues with me, including Mauricio Cárdenas, Maria Angélica Arbeláez, Alexandra Montenegro, Alejandra Díaz, Maria Eugenia Solarte, Aura Maria Londoño and Ana Maria Casas Castellón. A special thanks goes to Juan Pablo Calderon, who provided invaluable research support, time, and assistance in the production of this thesis, and Liliana Obregón and Olga Fernández de Soto, who helped to facilitate several contacts in Colombia. Finally, I would like to thank the millions of informal workers in Colombia, who inspired and motivated my work.

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ABSTRACT

BEYOND THE INVISIBLE: FORMALIZATION POLICIES AND THE RULE OF LAW IN THE INFORMAL ECONOMY

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George Mason University, 2010

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Trade liberalization in Latin America has substantially altered business opportunities and economic development in the region. As barriers to competing inputs have come down and foreign investment in the region has gone up, small, domestic firms have struggled to stay afloat. Many small businesses have survived by skirting the legal requirements to operate a business, including registration and taxation, thereby bringing their operating costs just low enough to earn a profit. As trade liberalization continues to reduce barriers to foreign competition, and domestic firms face increasing pressure to compete, these “informal” firms have come under increasing pressure to legitimize or cease operations. With strong pressure from the tax-paying business community, international organizations, and foreign industry, many countries have increasingly begun formalization programs that target informality as a reason for slow growth in the face of open trade.

In this thesis, I pose a straightforward question—is formalization good for economic development? This question opens the door to an evaluation of the underlying cause of

informality, the basis for the push for formalization, and an assessment of the likely result of such a process.

Formalization attempts to remedy the problems of low productivity and aversion to compliance with the law through economic incentives, such as tax discounts and streamlined business procedures that are intended to help firms make their way into the formal marketplace. However, in many developing countries, the informal economy is an economic consequence of trade pressures, and a legal consequence of a failed social contract between the state and its small business community.

In its current iteration, the formalization process is coupling the tools used to improve business practices and procedures with the legalization process for millions of existing informal firms. By doing so, the state is ignoring the dual legal and economic framework within which informal firms operate. Improvements in business processes are good for business and can help existing and intending formal firms succeed. But these are much less likely to overcome the deep-rooted failure of the state to address the needs of the bulk of the citizenry.

I argue that an effective formalization process must 1) address the terms of the social contract between the state and its informal economy, and; 2) make improvements in social programs to protect the health, safety and prosperity of existing informal firm operators. It is my contention that informal firms have largely rejected the state's rule of law contract because the firms are unwilling to cede their freedom to operate an informal business in exchange for state protection of property or rights that they rarely possess. As such, in order to not only reduce the growth of the informal economy, but also to improve the rule of law, the state must take aggressive steps to reform their arrangement with the informal economy by building dynamic linkages between formal and informal legal and economic frameworks. An immediate

step that states should take, I argue, is to implement programs that remove some hazards of operating an informal business by enforcing restrictions on the use of certain public space, providing safety equipment to street-based firms, and investing in improvements in the design of public space.

This modified formalization approach is not intended to rapidly eliminate the informal economy. Rather, it is aimed at improving the economic development of the state through an enabling, rather than a punitive approach. This modified approach will increase the value of the social contract and rule of law to informal firms; illuminate a pathway to voluntary legalization; protect individuals operating informal firms, and; improve access to education, training, and social services for all small firms. Capitalizing on the contributions made by the informal economy to a state's economic development may help to turn a destructive process into a growth opportunity.

PART I: The Informal Economy and the Formalization Process

Introduction

Economic growth prospects in Latin America are bleak. Poverty and inequality continue to grow despite promises of prosperity following trade reforms. Urban centers continue to dominate rural development, replacing domestic production with an import-based economy. And decent work becomes harder to find as foreign firms continue to push for low wages and de-unionized labor.

One of the direct impacts that the move toward trade liberalization since the 1990s has had in Latin America is an expansion of the urban informal economy. Increasing competition leads to a demand for low-cost labor; improved productivity and technology lead to less demand for unskilled labor; and fewer jobs for unskilled workers leads to increasing dependence on informal work for sustainable livings. Yet the informal economy is not only a mechanism for survival of the informal worker, it is a driving force behind the economic development of many developing countries.

This often overlooked engine of the economy has been festering for decades and has recently come under the microscope by states and international institutions. Major publications from the World Bank, the Inter-American Development Bank, the International Labor Organization, and the World Trade Organization, private consulting firms such as the McKinsey Global Institute, and domestic research institutions, have recently elevated the importance of the informal economy on the economic growth agenda of developing countries today. Despite

the vast differences in the reports from each of these stakeholders, most agree that growth of the informal economy is bad for economic growth, bad for business, and bad for the state.

The informal economy—which is often characterized by its lack of productivity, minimal capitalization, and usually, by illegality—consists of small firms that do not pay taxes or register with the state; temporary workers; self-employed and unregistered service providers; and hundreds of other insecure business operations. It makes up more than half of most developing country marketplaces, which is highly evident from a walk down any developing country city street.

The informal economy is generally considered to be harmful to long-term economic growth. As more and more small businesses and sole proprietorships conduct business outside the legal and regulatory framework of the state, the state is able to collect less and less in tax revenue and business registration fees. Yet dependence on state health services and social security programs continues to grow, emptying state coffers at impressive rates.

Given its size, scope of activity, and evidence to suggest its recent expansion, states are increasingly worried about how to reverse the trend toward informality. The response by many developing countries has been to institute a formalization program meant to unclog the process of economic growth by removing this supposed outgrowth of structural change due to liberalization. These *formalization* projects appear in several forms, but most attempt to use economic incentives to lure informal firms into the formal economy. These incentives range from information distribution about the benefits of formalization, to legal changes that make business registration easier or lower taxes for small businesses. The goal is a more streamlined business registration system and more affordable registration process, which is expected to attract presently informal firms into the formal economy.

In exchange for the economic benefits the state is offering with the formalization process, small firms will be expected to abide by applicable tax laws and business regulations in the operation of their firm. In order to determine the value of this exchange, small firms need to see both an economic advantage that surpasses that gained by operating informally, and a legal advantage gained by exiting the extralegal marketplace.

Successful formalization will require an economic gain for the informal firm. Many informal firms conduct cost/benefit analyses before determining that the informal sector offers more substantial economic and related benefits, such as flexibility in schedule and duration, and increased retention of profits. The additional income gained through the non-payment of taxes and fees may be the only real profit earned by the firm. Formalization in this respect must position the firm to generate profits after accounting for applicable taxes and fees.

But there is a second, often overlooked obstacle to formalization—what I call the broken social contract. There must be a perception by the informal firm that abiding by the law will yield some valuable macroeconomic benefit that is not available in the informal sector. One of the tangible benefits of operating a business in the formal sector is improved access to state legal institutions such as effective contract enforcement, recognition of property titles, improved access to the judicial system, access to more affordable credit, and small business promotion through government agencies. The state is responsible for providing the legal institutions that facilitate these benefits. But in many developing countries, businesses perceive the state as unwilling or unable to adequately and fairly provide these benefits to meet their needs. And despite substantive reform efforts and significant sums invested in rule of law reforms, informal firms continue to lack faith in the state's ability to provide for their needs.

Consequently, the informal economy has evolved its own legal institutions, capable of resolving many common disputes without resorting to the state.

For many small firms, moving into the formal economy would mean a loss of productive income as adherence to business laws and registration requirements would undercut any profit previously gained. This fact could prevent the majority of these firms from formalizing. Yet even if an economic incentive were sufficient to overcome this objection—that is, through sufficient tax discounts and waiver of registration fees—firms still must perceive a valuable legal benefit in formalizing. This requires a reconsideration of the social contract between the state and the informal firm. The state must be able to protect the interests of the small firm in the face of increasing competition and the firm must be willing to trust the state to defend its interests in the formal marketplace, and given the economic structure of many developing countries today, this barrier will be difficult to overcome. Weak rule of law and increasing distrust of the state to represent the interests of the poor makes any move toward formality unlikely in the absence of systemic reform.

I argue that if a state is to improve its economic growth prospects in the face of rising informality, it must be willing to reconsider how it perceives informality. The state must follow an approach that recognizes the duality of the modern developing country economy and that attempts to improve the lives of informal workers and firms, expanding their opportunities to voluntarily formalize and providing basic social services to those that do not. I propose a new, incremental approach that focuses on monitoring, training, and improving access to formal institutions. And while I do not disagree with the value of streamlining registration processes and lowering the costs of doing business, I argue that these efforts are best directed at the entrepreneurial sector, not the broader informal economy.

My contribution to this research complements a host of economic and social science studies that have carefully and extensively examined the role of an informal economy in the economic development process. As a social scientist and a legal practitioner, I believe that my approach lends a perspective that has largely been overlooked due to the mischaracterization of the informal economy as principally an economic concept. I argue instead that informality is by nature a legal concept—in essence, it is the provision of goods or services without the legal right to do so. Accordingly, my contribution attempts to broaden the analysis of informality and, more precisely, formalization, by highlighting the breach in the social contract between the state and the informal economic actors.

The thesis is divided into four sections. The first section addresses the nature of the informal economy and why it is growing in many developing countries. Chapter 1 will provide the terminology and tools necessary to conduct a thorough analysis of the informal economy by defining what that term means and how it is characterized. Chapter 2 will describe the role that trade liberalization has played in motivating states and firms to push for the formalization of the informal economy. Chapter 3 will explain what steps states in Latin America, principally in Colombia, have taken in order to rid their economies of informal activity. Chapter 4 will present my field methodology and provide a more precise exposition of my thesis.

The second section looks in detail at Colombia as the principal case study for this thesis. Chapter 5 introduces the Colombian informal economy and explains why it was selected as the case study for this thesis. Chapter 6 describes the trade liberalization process in Colombia, which led to their push to formalize the informal economy. Chapter 7 describes the approaches that Colombia is taking to formalize their economic activity, including interviews with key actors in the formalization process. Chapter 8 describes the reaction to formalization within the

informal economy, including interviews with several small firms and a look at recent data by the Colombian statistics agency.

The third section provides my analysis of the formalization process. After a brief introduction, Chapter 9 explains the role played by the rule of law in the informal economy and describes how it may be the central feature holding back the success of formalization projects. Chapter 10 critiques the single formalization approach by showing the multidimensional nature of the informal economy. And chapter 11 attempts to debunk the myth of productivity gains from formalization.

The final section of the thesis provides a series of recommendations that could help a developing country economy pursue the successful reduction in their informal economy as a long-term economic growth strategy. I end the thesis with some brief concluding remarks.

The formalization process as it is currently conceived faces significant barriers to success. Economic incentives cannot adequately protect the profits of most informal firms and the firms are cognizant of this fact. Secondary benefits to formalization, such as access to credit and formal legal institutions, are perceived by many firms as empty promises, weighed down by corrupt officials and complicated access. The informal economy survives because it operates in a state of nature, outside the costly and complicated legal and regulatory structure of the state. Formalization policies incorrectly assume that joining the formal marketplace and leaving this state of nature behind, is the goal of informal firms.

Chapter 1: Defining the Informal Economy

The driving force behind any business endeavor is generally the generation of income for the owner. A good business idea is one that has successfully evaluated the demand for a good or service, effectively developed an efficient system of producing and delivering that good or service, and that correctly judges the market economy in order to produce revenue. This is as true for Microsoft as it is for an ice cream vendor at the beach. Both are in the business to earn profits and both intend to remain in business until they are no longer profitable.

In developed countries, the process of forming a business requires more than a great idea and some investment. It also requires registration and often compliance with certain requirements, such as licensing and certification. The basis of this registration requirement is two-fold: it allows the state to track your business activity, ensure compliance with regulatory requirements, and to protect consumers that have dealings with your firm; and, it allows the state to tax your business based upon its earnings and corporate structure. Without registration, a business in a developed country will be considered outside of the formal economy. Its owner will be held liable for any damages caused by the business in its dealings, for any violation of licensing or regulatory requirements for that type of business, and for any non-reported revenue for tax purposes. In other words, it will be highly vulnerable to legal and financial ramifications that usually outweigh the cost of registering with the state. This is largely the reason for the small percentage of informal firms in developed countries.

A developing country business developer follows a distinct route. The ramifications for failing to register a business in a developing country are practically non-existent. Despite the presence of laws that require businesses to register and increasingly streamlined procedures for registering a business, enforcement of and respect for the law is painfully weak. Instead of the law presenting a set of severe punishments for operating a business without a license, weak rule of law has led to a strange incentive to intentionally avert licensing altogether in order to profit from the avoidance of taxation and other potential economic gains. As a business is designed to enrich the owner, given the minimal risk of punishment, operating without a license is a reasonable business decision.

This section considers the nature of the informal economy in developing countries, principally in Latin America, where much empirical research was conducted. I begin by exploring the various definitions of the informal economy over time and how it has developed into a useful economic and political concept today. I move on to an examination of the root causes of informality from a variety of viewpoints. I conclude by positing a working definition of informality that will drive the remainder of this thesis.

Setting the Stage of Informality

Since its inception, the informal economy has been categorized by different authors in distinct ways. It has been called a Marxian reserve army of labor,¹ a survivalist economy,² and a

1. KARL MARX, *Das Capital* 790 (1867).

2. RAFAEL LA PORTA AND ANDEI SHLEIFER, *The Unofficial Economy and Economic Development*, Tuck School of Business Working Paper, 3 (2009).

key entrepreneurial sector of the broader economy.³ However they choose to perceive the participants in the informal economy, most authors agree that the informal sector is a substantial portion of the overall economy, a dynamic driving force behind economic activity, and as some argue, a permanent and growing fixture in the overall economy.⁴

As the following pages illustrate, informality refers to a portion of the overall domestic economy that operates without many legal protections or perceived obligations. It consists of a group of workers and firms that play an important role in economic growth, providing workers with jobs that are often perceived as better than those in the formal sector; or at least better than unemployment. Depending on the definition used, the informal economy comprises between 30 percent and 90 percent of work in most developing countries. Accordingly, determining what the informal economy encompasses is a key element in understanding its impact on economic growth and development.

Informal economic activity can be found in nearly every facet of economic life in developing countries. It includes street vendors, domestic servants, sidewalk salesmen, and entertainers. It also includes a growing number of microenterprises, home businesses that piece together textiles for sale to retailers, repair cars, or provide access to long-distance phone service in small shops around town.

Informal laborers, often the most disadvantaged economic actors,⁵ include individuals working on their own account or as employees of informal or formal firms. Informal firms, on the other hand, include those micro, small, and even some medium and large enterprises, that

3. See HERNANDO DE SOTO, *The Other Path: The Economic Answer to Terrorism* (Basic Books. 2002).

4. MARTHA CHEN, *Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment*, 46 DESA Working Paper, 11 (2007).

5. *Id.*, at 3.

to some degree operate without state registration, paying taxes, or providing pensions and social security to their employees. Informal laborers and firms operate together in the broader economy to provide goods and services that others need, and together, they occupy the informal economy.

In this chapter, I will address the fundamental question: what is the informal economy? In so doing, I will focus primarily on the operation of self-employed workers and microenterprises. By no means do I discount the importance of the informal laborer who is employed by a formal or informal firm in understanding the informal economy; however, the formalization process that I critique in this thesis is largely meant to formalize firms, rather than to improve working conditions or labor contracts. Accordingly, while I will draw attention to key reforms that will help both firms and workers, firm activity will serve as the foundation of this analysis.

Foundational Descriptions of Informality

Economic activity can generally be evaluated by both economic theory and law, depending on the goal of the research. In the case of informality, although economic theory has driven the vast majority of relevant research, legal analysis would seem to be a necessary tool in developing a proper understanding of the informal economy. In fact, the very distinction—formal versus informal—refers to the legality of the activity. The informal economy suggests work in which one or more legal characteristics that would make a firm or worker legitimate in the face of the law. Generally, this includes registration with the chamber of commerce or other

business registration entity, affiliation with social security, and payment of taxes. Each of these concepts can be used as a dividing line behind formal and informal work.

Prior to the promulgation of the term “informal” to refer to certain business practices, workers that contributed productively to the domestic market without state recognition were largely considered either unemployed⁶ or an “excess reserve army” of workers laying in wait of formal employment opportunities.⁷ Rather than seeing informal workers and firms as contributing to the broader economic structure and success of the country, they were excluded from formal statistics and largely ignored.

The first documented institutional use of the term *informal economy* was in a 1972 report on Kenya from the International Labour Organisation.⁸ In this report, the term was used to explain what was then considered a completely separate economy operating alongside formal market activities. The report used a term coined the previous year by Keith Hart, who was conducting research in Ghana at the time.⁹ Hart challenged the previously-held belief that large swathes of the developing world were unemployed by showing that in fact they were gainfully employed but that their employment was disconnected from the growing bureaucratic structures in developing states.

Perhaps the best way to gain an understanding of what is informal, is to define what is formal. In a more recent study, Keith Hart suggests that “what makes this lifestyle ‘formal’ is the regularity of its order, a predictable rhythm and sense of control that we often take for

6. Hart’s definition of ILO interpretation prior to his report.

7. JOSÉ NUN, et al., *La Marginalidad en America Latina*, 2 ILPES-DESAL, working paper (1967).

8. INTERNATIONAL LABOUR ORGANISATION, *Employment, Incomes and Equality: A Strategy for Increasing Productive Employment in Kenya*, (1972).

9. KEITH HART, *Informal Income Opportunities and Urban Employment in Ghana*, 11 The Journal of Modern African Studies (1973).

granted.”¹⁰ Following this logic, Hart argues that it is the advent of the capitalist system that gave rise to the existence of a formal economy. Prior to the establishment of a state system of business regulation, taxation, and legal personification, all firms and workers formed part of what we today consider the informal economy. States took certain business interests under their protection and, in exchange for taxation and regulation, offered protection from competition, access to credit, and a voice in state governance.¹¹

Thus, distinguishing the formal and informal sectors of the economy may be a matter of better understanding the creation of a bureaucratic system that ineffectively garnered protection for only one segment of the population. Read another way, we might argue that the formalization process in many developing countries is incomplete and that many firms have been left behind by the state.

Root Causes of Informality

Understanding where the informal economy comes from can help us to discern how to measure and monitor it. Yet again, a more appropriate research question may be where the formal economy comes from. Distinct from the modern processes that I will address in a subsequent chapter, early formalization, or the inclusion of workers and firms in the state legal and regulatory structure, took place worldwide as states began to develop regulatory mechanisms for business operations and labor. Through the implementation of laws and

10. KEITH HART, *Bureaucratic Form and the Informal Economy* 21 (Basudeb Guha-Khasnobis, et al. eds., 2006).

11. See, e.g., *Id.* at 24.

policies, and the application of inspections and penalties for failure to follow those laws and policies, states began to create what we would consider the formal economy.

Urbanization has played a central role in expanding the number of informal workers and firms. As more individuals transitioned from rural activities to urban activities and migrated to the major cities to look for better income, more small, informal firms appeared on the scene. As this phenomenon grew rapidly, the state was less able to monitor and thus regulate the growing number of economic activities taking place. The International Labour Organisation notes this dimension of informality in Latin America by characterizing informality as, “an urban phenomenon, resulting from high rates of rural-urban migration, structural adjustment programmes of the 1980s and 1990s and/or for some from burdensome regulations and lack of recognition of the property rights and capital of informal operators.”¹²

So, while the state continued to extend its regulatory reach, its ability to encompass the entire field of business activity was impaired. In modern-day developed countries, the state was more successful in securing the compliance and regulation of most businesses, leaving significantly less economic activity outside the auspices of the state in the small, developed country informal economy. Yet in developing countries, the state has been unable to apply its regulatory structure to a large portion of its population, leaving swathes of firms and workers to fend for themselves in the traditional, or informal economy.

With the establishment of a formal economy came frustration with the remaining informal economy. Informal firms undermined the business of formal firms by operating at a lower cost and meeting market demands that formal firms could not. Firms that employed low-

12. INTERNATIONAL LABOR ORGANISATION, 298th Governing Body Policy Document (ILO Committee on Employment and Social Policy 2007).

cost informal labor could keep their costs below those of firms that fully adhered to the law prohibiting the use of informal labor. Foreign investors shied away from countries where unregulated business was rampant, fearing unfair competition and unequal application of tax laws by the state.

In addition, the vast majority of informal workers and firms occupy the lower brackets of income, earning only enough income to survive and maintain their operation. Poverty levels in the informal economy are astounding and dependence upon basic state services is high, despite the lack of contribution to service providers. Accordingly, a large informal economy quickly became associated with underdevelopment and a hostile business environment. Developing country leaders began to perceive the informal economy as a threat to domestic and foreign business interests and sought an answer to this growing problem.

Economists clamored to solve the crisis of the large informal economy, focusing initially on a need to expand capitalist development. This “modernization” approach presumed that as the benefits of formal market participation became more apparent, informal firms would voluntarily slip into the formal economy. Ironically, it may have been this drive toward capitalist development that led to the unintended growth of the informal economy in the first place.

Relevant literature points to two key ideas as to what causes informality. First, and most prominent in the literature, is taxation and the related costs of doing business. Characterized by some as the legalist school¹³ and others as the romantic view,¹⁴ this approach sees informal firms as frustrated entrepreneurs stymied by an overbearing state. Second, and most relevant to this thesis, is the institutional analysis of informality. Beyond economic

13. See, e.g., CHEN, at 3.

14. See, e.g., SHLEIFER.

incentives lie the foundations of a weak state that is unable to fairly and adequately provide benefits to its citizens, and that lacks the ability to enforce its own laws. Weak legal institutions stand out within this framework as a driving motivator behind informality.

Economic Analysis: Taxes and Regulations

The root cause of existing and growing informality, according to many economists and social scientists, has been the inefficient or ineffective state tax and regulatory system. This theory suggests that the problem consists of: 1) a rising tax burden when operating in the formal economy; 2) increasing state regulation of business and labor, and; 3) declining tax morality.¹⁵ As the costs of operating formally increase, the appeal of informality grows.

An increasingly regulatory state can motivate individuals to evade the costs associated with doing business by operating in the shadow of the state. Friedrich Schneider, who conducted a global survey and analysis of informality, considers this to be the firms' reaction to an overbearing state, which leads to significant tax evasion and "institutional sclerosis."¹⁶ As the state makes more efforts to regulate its firms, more firms choose to evade the state and operate informally. The result is a state that is unable to effectively enforce its laws and collect the taxes that it needs to pursue its economic development objectives.

15. FRIEDRICH SCHNEIDER & DOMINIK ERNSTE, *Increasing Shadow Economies All Over the World - Fiction or Reality*, 26 IZA Discussion Paper, 25-26 (1998).note that "declining tax morality" will later be associated with declining rule of law. (note that "declining tax morality" will later be associated with declining rule of law).

16. CHRISTOPHER BAJADA & FRIEDRICH SCHNEIDER, *Size, Causes and Consequences of the Underground Economy* 2 (Ashgate. 2005).

The World Bank published an extensive and comprehensive analysis of the Latin American informal economy in 2007. In this report, the authors provide a brief discussion of the causes of informality. According to the report, the informal economy is caused by segmentation in the labor market that prevents informal workers from taking formal jobs, high barriers to entry in the formal economy resulting from excessive regulation, and excessive tax and regulatory burdens placed on formal firms.¹⁷ The report also integrates the economic motivation of leaving (or never joining) the formal sector on account of a cost-benefit analysis that yields more overall income due to less operating costs in the informal economy.¹⁸

The report authors argue that the costs of formality tend to push small firms into informality:

The high levels of informality found among microenterprises in developing economies can be interpreted as resulting from profit-maximizing decisions by private firms subject to environmental constraints that increase the costs or reduce the benefits of formality – for example, high costs of firm or property registration, or market and government failures in credit markets, and contract enforcement mechanisms.¹⁹

According to this perspective, informal firms calculate their cost of doing business and compare it to what they would pay were they formal. This assumes that informal firms are aware of the regulatory processes involved in the formalization process, and that they can make rational calculations of the operating costs in each sector for comparative analysis. In the case of some small firms, such as those textile manufacturers or domestic workers, this assumption may be correct. Yet for the thousands of other small firms, including street vendors, transport operators, and personal service providers (tour guides, car washers, performers), it is illogical to

17. GUILLERMO E. PERRY, et al., *INFORMALITY: EXIT AND EXCLUSION 1* (The World Bank. 2007).

18. *Id.* at 2.

19. *Id.* at 138.

presume such analysis was done. Rather than being an economic comparison, it seems more likely that the decision was based upon an economic opportunity that was available at the time and that offered at least basic income for the individual to survive.

Hernando de Soto is one of the best known economists looking at the role of the regulatory structure in determining the growth of the informal economy. In his book, “The Other Path”, de Soto cogently addresses the challenges faced by informal communities in maintaining property rights, finding and keeping formal jobs, and conducting business in developing countries, all as a result of excessive state regulation.²⁰ De Soto conducted an extensive survey of the informal business and property markets in Lima, Peru, in the midst of the violent Shining Path movement (hence the name for his book), and mapped the time-consuming and costly procedures that informal firms need to comply with in order to become formal.

In de Soto’s view, the root cause of informality was in large part the rise of a bureaucratic system that established regulatory hurdles that discouraged firms from joining the formal economy. In particular, de Soto focused on the state requirements to form a business and register property. He argued that excessive regulation creates costs and time inefficiencies that make it more burdensome to register a business and pay taxes than to remain informal. His theories formed the basis of what was later characterized as the legal school of thought on informality. As will be discussed in a subsequent chapter, de Soto’s work formed the basis of the World Bank’s *Doing Business* group, which surveys countries based upon their regulatory systems, among other things, and categorizes them based on the ease of doing business in the country.

20. SOTO.

The underlying assumption in de Soto's analysis is that informal businessmen are repressed entrepreneurs in need of an easier way to self-formalize. Contrary to the cost-benefit analysis, which posits informal firms as intentionally created to avoid the costs and related drawbacks of operating formally, de Soto suggests that informal firms are eager to join the formal marketplace but face incredible cost and time hurdles in doing so. Yet as the World Bank argues, regulatory costs are only one of the considerations made by informal firms, and may be less important than other factors, including flexibility and opportunity.²¹

De Soto's approach was recently criticized in a paper by World Bank economists Rafael La Porta and Andres Shleifer in which they argue that de Soto's "romantic" view is unrealistic. In their estimation, the informal economy largely consists of workers and firms uninterested in formalizing because they have been successful as a direct result of capitalizing on loopholes in an overly bureaucratic and rigid formal economy. In reality, there is little possibility that these small informal firms could survive if formalized since they are highly unproductive and thrive in a culture that disrespects the rule of law.²²

Institutional Analysis and the Rule of Law

What is the motivation for an informal firm to become formal, that is, to register with the state and pay appropriate taxes and other fees, when they do not perceive that the state does enough to provide necessary services and protections to the firm or worker? This question has been characterized as the problem of the "dysfunctional social contract," whereby "the

21. PERRY, et al., at 163.

22. SHLEIFER.

state is not complying with its designated roles and individuals therefore see little point in playing by its rules.”²³ With little trust in the state, and a perception that the state is doing very little or nothing to facilitate a productive business and social development environment, and with weak enforcement mechanisms in place to curb illegal activity, large groups of firms and workers see informality as a reasonable option.

The role of institutions in economic development is fundamental. An ineffective or failed state that is unable to provide adequate market and legal institutions is less likely to enjoy sustainable economic growth than a state that has a functioning market economy, effective judiciary, and trustworthy law enforcement. Yet even in the face of improvements in state institutions, it is also the perception of an ineffective or failed state that can yield the same result.

Douglass North posits that institutions “form the incentive structure of a society” and that these in turn are the foundation for economic performance.²⁴ Institutions consist of formal and informal constraints as well as their enforcement characteristics. They determine transaction costs for firms and individuals, which constitute part of the costs of production. Only when there are no transaction costs are institutions unnecessary.²⁵ Because economic markets are imperfect and include high transaction costs, institutions matter.

Institutions are particularly significant in the context of the informal economy. There are two sides to the institutional analysis of the informal economy. First, the perception of a weak state by firms gives the impression that the state will be unable to provide adequate and equal benefits for all firms that comply with the law. This may manifest with respect to access

23. PERRY, et al., at 216.

24. DOUGLASS C. NORTH, *Economic Performance Through Time*, 84 *American Economic Review* 359(1994).

25. *Id.*, at 360.

to the judiciary to enforce contracts, enforcement of property rights, or effective access to legal remedies.

Second, a state that lacks effective enforcement mechanisms may generate a culture of law avoidance, or illegality. Lack of comprehensive and fair enforcement mechanisms may lead some individuals to bypass the law because the risk of doing so is low. This, in turn, may influence the decision of others to do the same, leading to a growing population functioning outside the law.²⁶ Take compliance with traffic laws as an example. In many countries, red lights are treated as stop signs, especially at night when the risk of being robbed at the stoplight is greater than the risk of being caught for ignoring the law. With no significant sign of being caught, and growing distrust in the state, this practice has become commonplace and has spread to daytime usage.

A culture of law avoiders substantially weakens the rule of law, which North emphasizes as one of the key elements of economic development. He says that long-run economic growth cannot occur in the absence of rule of law.²⁷ Rule of law refers generally to the supremacy of law over the sovereign, requiring the state to respect and adhere to the law. In a more practical sense, rule of law refers to the legitimacy of the state as perceived by its citizens. Accordingly, most measures of the rule of law are perception-based measures.

De Soto, while a strong advocate of the overbearing regulatory state theory, also recognizes the problem of weak institutions. “We can say that informal activities burgeon when the legal system imposes rules which exceed the socially accepted legal framework – does not honor the expectations, choices, and preferences of those whom it does not admit within its

26. See, e.g., PERRY, et al., at 216.

27. NORTH, at 367.

framework – and when the state does not have sufficient coercive authority.”²⁸ However, de Soto perceives the legal barriers to formality as arising from the enforcement of laws that deter firms from operating formally, rather than from a lack of access to good legal institutions and effective enforcement regardless of the state of registration.

Rule of law in Latin America is generally very weak. The perception of government enforcement of property rights and of fair and impartial courts is lower than in OECD countries, as well as in many other developing country regions. “On average, firms in Latin America are less confident that their judicial system will enforce contractual and property rights disputes than are firms in other regions of the world.”²⁹ Distrust in the state has given rise to a culture of law avoiders that find it beneficial, and often lucrative, to operate otherwise legitimate business endeavors outside the regulatory purview of the state.

Avoidance of tax and business registration laws is further influenced by the law enforcement environment. When the risk of law enforcement is low, and the perceived benefit of paying taxes and regulatory fees is also low, there may be a higher incidence of avoidance. Yet rather than simply a matter of weak deterrence, several authors comment that it is the broader exchange of taxes for benefits that leads some countries’ citizens to comply with the law while others do not, despite similar levels of enforcement.³⁰ Perry and Maloney convincingly argue that state taxation can be conceived of as a contract between the state and its citizens, and that when the citizens do not perceive that the state is upholding their performance obligations, there is little desire for the citizen to do so either.³¹

28. SOTO, at 12.

29. PERRY, et al., at 220.

30. See, e.g., Id. at 227-28.

31. Id. at 228.

The role of institutions in sustaining informal economic activity has not been extensively addressed by the literature, yet appears to play a significant, perhaps even a central role.

Economic factors no doubt also play an important role in driving firms into and out of informality, but institutions form the framework in which ultimate cost-benefit decisions are made. Within the institutional framework, rule of law may be the most significant factor in facilitating an environment that welcomes, and perhaps even encourages informality.

Characterizing Informality

It seems logical to begin an analysis of informality by describing what the informal economy looks like. Unfortunately, it is difficult to pinpoint any particular characteristics that are consistently found in every informal economy. Thus, we are left to generalizing some common characteristics to discern a pattern.

The Colombian statistics agency, DANE, provides useful statistics of some common characteristics of informal firms. For instance, it found that informal firms are generally located outside of a traditional commercial premises, usually conducting business out of their home or on the street; most operate as natural persons (similar to a sole proprietor in the United States) as opposed to formal firms which may take this form or may operate under a limited liability corporate structure; most firms are oriented toward services, whereas formal firms tend toward trade; most firms have only been in business for three years or less, although roughly 20 percent

are more than 10 years old; both costs and revenues are lower for informal firms than for formal firms; and the ratio of capital to labor in formal firms is roughly double that of informal firms.³²

Early descriptions of the informal economy saw it as separate and apart from the formal economy. In the formal economy, firms receive protection from the state through their registration and obedience to the rule of law, including protection of their property in legal proceedings, protection from police harassment, and access to a range of credit and services.³³ The informal economy, then, became what remained of the traditional economy – unprotected and unregulated by the state, yet by no means unregulated on an informal level.³⁴

However, the informal economy does not stand in stark contrast to the formal economy. In fact, the two concepts are largely intertwined and depend on one another for survival in many developing countries. Yet states continue to view these “two economies” as utterly distinct entities. Informal firms and labor represent the limited ability of the state to provide protection to its entire population. According to Hart, “what is at stake here is whether society is just one thing – one state with its rule of law – or can tolerate a measure of legal pluralism, leaving some institutions to their own devices.”³⁵ I will revisit this idea in chapter 10.

According to Victor Tokman, who has written extensively on informality, “[i]ndependent 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 term of capital requirements. Additional features include

32. Microestablecimientos: Estructura 2006-2007. (2007).

33. HART, Bureaucratic Form and the Informal Economy at 24.

34. Id. at 31.

35. Id. 31.

limited sharing of the property of the means of production and a majority of waged workers laboring without contracts and protection.”³⁶

For Tokman, informal firms appear to be a distinct entity within an economy that operate on a small, unsophisticated level. This activity would most certainly include street vendors, home workers, and many small shops. “[T]he informal sector operates in a realm between “the underground” and legality, allowing the informal producer to obtain access to what she or he evaluates as important while minimizing the risks associated with illegality.”³⁷ Tokman suggests that states adopt a dual-regulatory approach that offers protection to informal enterprises and workers without, at least temporarily, requiring adherence to the rigid regulatory requirements of formal enterprises, in order to work toward an eventual single, all-encompassing regulatory regime.³⁸ I discuss a modified version of this approach in the recommendations chapter.

Yet if we examine more recent analyses of the informal economy, it appears more dynamic than Tokman asserts. Martha Chen, for instance, recently published several papers addressing the fluid relationships between formal and informal work in a developing country economy, taking into account not only independent contractors and small enterprises, but also laborers in formal enterprises, production chains, and dual-employment individuals. “The informal workforce is large and heterogeneous, comprised of both the self-employed in informal

36. VICTOR E. TOKMAN, *Integrating the Informal Sector in the Modernization Process*, 21 SAIS Review 45, 45-60 (2001).

37. VICTOR E. TOKMAN & EMILIO KLEIN, *Regulation and the Informal Economy: Microenterprises in Chile, Ecuador, and Jamaica 2* (Lynne Rienner. 1996).

38. *Id.* at 8.

(i.e. unregulated and small) enterprise and waged workers in informal (i.e. unregulated and unprotected) jobs.”³⁹ For Chen, there is much more to the informal economy than hidden work.

Chen analyzes what she considers to be the three schools of thought relevant to the informal economy: dualist, structuralist and legalist. The dualist school, embodied in large measure by Tokman as well as Harris and Todaro, tends to view the informal economy as distinct from and with little interaction with the formal economy. Firms that operate informally appear distinct from firms that operate formally – there is relatively little overlap. Adopting this view, La Porta and Shleifer characterize informal firms as unproductive and delinked from the broader economy. “The vast majority of informal firms appear to begin and end their lives as unproductive informal firms.”⁴⁰

The legalist view, best embodied by Hernando de Soto, emphasizes that informal activity exists only when the costs of doing business are too high.⁴¹ The law serves as a barrier to productive, formal activity, leading entrepreneurs to disconnect from it in order to carry-on their economic activity in the freedom of the unregulated marketplace. The World Bank *Doing Business* group identified with this approach and has performed annual analyses of the legal and regulatory impediments to doing business in every country, emphasizing the negative investment climate that too much regulation can create.

La Porta and Schleifer characterize de Soto’s approach as hopeful, but unrealistic. In their view, reducing the barriers to doing business, while always a productive avenue for economic growth, have little to do with reducing informality. Informal firms are vastly different

39. MARTHA CHEN, *The Business Environment and the Informal Economy: Creating Conditions for Poverty Reduction* 8 (2005).

40. SHLEIFER, at 35.

41. See, e.g., SOTO, at 12.

from formal firms, operating on a much smaller, unproductive scale and driven by uneducated and less savvy managers.⁴² In their view, the optimism expressed by de Soto will lead to inefficient policy outcomes. Instead, the focal point should be on revitalizing formal firms rather than attempting to convert informal firms into formal firms.⁴³

The structuralist school, followed by Portes, among others, tends to see capitalist development as the creator of informality, with formal firms subjugating informal workers and small enterprises to maintain competitiveness through low labor and capital costs. In their description of the structuralist school, Alejandro Portes and Richard Schauffler explain how their approach differs from the legalist school. They contend that de Soto's recommendation to remove the regulatory barriers to operating a business would not only have little positive impact on informality, but that it may destroy the capitalist system itself.⁴⁴ In the view of Portes and Schauffler, "[i]nstead of the Trojan Horse that will ultimately break down the fortress of 'mercantilist' privilege, the informal sector in fact represents part of the routine operation of capitalism as it is presently organized in Latin America."⁴⁵ Accordingly, their solution focuses on enhancing the relationships between formal and informal enterprise through capital investments in modern industrial and service sectors.⁴⁶

Chen critiques these schools as not representative of the true nature of the informal economy, which she views as dynamic, fluid, and inter-connected with the formal economy. Her definition of informality includes "all forms of 'informal employment'—that is, employment without labour or social protection—both inside and outside informal enterprises, including

42. SHLEIFER, at 3-5.

43. Id., at 35.

44. ALEJANDRO PORTES & RICHARD SCHAUFFLER, *Competing Perspectives on the Latin American Informal Sector*, 19 *Population and Development Review*, 47 (1993).

45. Id., at 47-48.

46. Id., at 55.

both self-employment in small unregistered enterprises and wage employment in unprotected jobs.”⁴⁷ The contribution that this definition makes to the analysis of informal economic activity is significant. This definition includes workers that work both formal and informal jobs (e.g., moonlighting), wage workers in firms that fail to register with the state, homeworkers (what Chen calls “industrial outworkers”), and informal enterprises. From this perspective, informal work is not easily identifiable, not homogenous, and certainly not disappearing.

Perry and his co-authors at the World Bank agree with the heterogeneous context emphasized by Chen, and add that the rationale for becoming informal is largely dependent upon circumstances such as availability of a living wage job in the formal economy, tax and benefit rates, the legal and regulatory structure of the state, and other barriers to entry.⁴⁸ They find that some workers choose to exit the formal economy in order to develop more productive opportunities in the informal economy, whereas others are excluded from the formal marketplace due to a lack of jobs and regulatory barriers to entry.

Informal work can be found in a variety of sectors. It can include outright informal operation of a firm or sole proprietorship, domestic services such as housecleaning and childcare, financial services, construction and industrial work done as independent contractors or day laborers, or employment in a firm that does not register the employee. It can also include individuals that work formal jobs but that take a second, unregulated job, to produce additional income. And it can also include individuals that work in jobs that would otherwise be formal but for their ineligibility to work (i.e., illegal immigrants).⁴⁹

47. CHEN, *Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment*, 2.

48. PERRY, et al.

49. FRIEDRICH SCHNEIDER & DOMINIK H. ERNSTE, *The Shadow Economy: An International Survey* 44 (2002).

Informal Firms - Entrepreneurial or Survivalist?

In his research, de Soto uncovered an economic sector bursting with life and entrepreneurial activity. He went further than Hart in merely identifying informal laborers and firms as part of overall economic activity; de Soto classified these workers as the entrepreneurial foundation of the economy.⁵⁰ He saw informal workers as ingenuitive in their ability to fill gaps between formal supply and general demand, especially in areas such as street vending and transportation. These workers used a system of informal codes of conduct, street knowledge, and business acumen to carry-out contracts, establish service routes, and provide protection to one another. Their principal dilemma, according to de Soto, was the complexity of the regulatory system by which they would have to comply in order to benefit from formality. In other words, these firms and workers wanted to be formal in order to benefit from social services, state protection, property rights, and legally enforceable contracts, but they either could not afford or did not understand how to comply with the complex business and property registration systems in their countries.

De Soto's work inspired a host of literature on business deregulation coming in the midst of the Washington Consensus economic policies being promulgated in many developing countries, which focused on minimizing the role of the state in economic affairs. The World Bank began to track the process of easing regulatory complexities and costs in all countries and published these findings in their *Doing Business* annual publications. Countries earned high

50. See, e.g., CATHY A. RAKOWSKI, *Contrapunto* 161 (1994). (discussing the rise of de Soto's point of view that informal firms were really frustrated entrepreneurs); see also PATRICIA FERNANDEZ-KELLY & JON SHEFNER, *Out of the Shadows: Political Action and the Informal Economy in Latin America 2* (Pennsylvania State University Press. 2006).

rankings from the Bank for easing the complexities and lowering the costs of starting a business, registering property, and a host of other related tasks.

The effect of deregulation in many countries has been to ease the process of starting a business, making it much faster and more affordable for entrepreneurs to voluntarily enter the formal economy and benefit from it. In many cases, deregulation has also made the regulatory process more transparent by publishing incorporation procedures online, for instance, and cutting down on the ability of government agents and middlemen to profit from the built-in delays and complexities of the process.

However, looking back upon the original conception of the informal economy, de Soto's "fix" appears to focus on making the formal economy more efficient, rather than reducing the negative effects or scope of the informal economy. A helpful visualization of the formal economy is to picture a large umbrella, which represents the state's regulatory system. Since the inception of the state, this umbrella has grown in its coverage and has brought more and more people within its protection from the unregulated storms outside of its coverage area. However, a weak or developing state has neither the resources nor the popular support to expand the umbrella over the entire marketplace. Thus, those outside of the protection of the umbrella are faced with two choices – find alternative mechanisms to weather the free market storm, or get wet.

Staying with this visualization, we might perceive de Soto's deregulation approach as an effort to make a more efficient umbrella, one that eases relations within the formal sector – those covered by the umbrella – and one that reduces barriers to voluntary entry into that protective scheme. Rather than trying to expand the state's coverage, de Soto's approach focuses on creating more pathways for voluntary entry into the formal economy.

Complementing de Soto's deregulation approach, the World Bank's Loayza argues that informality arises when states impose excessive tax burdens without the institutional mechanisms needed to enforce them.⁵¹ In his 2004 study, he defines the informal economy as: "(non-criminal) economic activities that go undeclared specifically in order to avoid compliance with costly regulation (in particular employment protection laws), tax payments, and social security contributions."⁵² This argument maintains the assumption that informal firms are poised for growth in productivity once regulatory processes are streamlined.

Critics of the deregulation approach have argued that the informal economy, while potentially entrepreneurial in spirit, is a much more dire state of affairs than we think. "[G]iven the information we have, it does not seem adequate to regard all those who participate in the informal economy as entrepreneurs, capitalists, or bourgeois...In a large percentage of cases, this would clearly be a complete distortion of reality."⁵³ These critics have gone so far as to criticize the use of the term microenterprise to classify sub-economic activities as equivalent to a small business in a developed country.

La Porta and Shleifer also take issue with de Soto's "romantic view".⁵⁴ In their estimation, the informal sector is not entrepreneurial or productive in any sense. Rather, they see the informal sector as an outlet for basic, sustainable income, a "livelihood to millions,

51. NORMAN A. LOAYZA, *The Economics of the Informal Sector: A Simple Model and some Empirical Evidence from Latin America*, 1727 World Bank Policy Research Working Paper (1997).

52. NORMAN LOAYZA, et al., *The Impact of Regulation on Growth and Informality: Cross-Country Evidence* 129 (Basudeb Guha-Khasnobis, et al. eds., 2007).

53. ANIBAL QUIJANO, *The Growing Significance of Reciprocity from Below: Marginality and Informality Under Debate* 147 (Faruk Tabak ed., 2000).

54. SLEIFER, at 1-2.

perhaps billions, of extremely poor people.”⁵⁵ These people are seen as less educated and less likely to succeed in the formal economy, by the authors.

De Soto’s ideas underlie many formalization approaches today, which tend to focus on regulatory streamlining. Yet this approach does little to address the low level of demand for formal institutions and the expanding culture of rule of law avoidance.

Moving even further away from the entrepreneurial view, La Porta and Schleifer define the informal economy as a “manifestation of underdevelopment”⁵⁶ The results of their survey analysis show that informality is closely linked with GDP per capita – more poverty leads to more informality. They call this the “dual view” and suggest that the best approach to ridding a country of informality is to develop more formality by focusing resources on microenterprise development, for instance.

Perry and Maloney argue that productivity needs to be at the center of the effort to reduce informality: “formality can be seen as an input in the production process for which small firms have little need.”⁵⁷ At early stages of development, profitability, although not necessarily productivity, requires avoidance of state regulations in order to maintain sustainable income. Complying with the law would require the firm to divulge the majority, if not the totality of their earnings.

Microenterprise promotion is an important goal of the formalization process. Microenterprises constitute the bulk of economic activity in most developing countries. For a microenterprise to succeed, it must be able to operate productively, generating net profits while

55. Id., at 3.

56. Id., at 11.

57. PERRY, et al., at 9.

complying with the law. However, most of the micro firms in the informal economy are unable to generate profits in the face of legal compliance. So, they choose to operate outside the law.

De Soto's approach assumes that informal firms are productive or potentially productive in nature, in need only of capital and faster access to formality. La Porta and Shleifer critique this view as out of line with the reality that informal firms bear few similarities to formal firms, and that their uneducated managers have little desire to formalize their firms. Their survey data shows that virtually no existing formal firms began as informal firms.⁵⁸ This suggestion is confirmed by Colombian data indicating that 80 percent of informal firms have been in existence for less than three years, and the lack of evidence that existing formal firms began as informal firms. The authors note that it is possible that a small number successfully formalize, but argue that this may be through linkages to the formal economy rather than through self-motivated business interests.⁵⁹

La Porta and Shleifer conclude that the dualist approach may be the most logical, and that developing countries should not see the informal economy as a potential growth sector. Rather, they contend that support programs should continue for informal microenterprises but that the majority of the emphasis should be on formal business development. "Such [formal business] formation must perhaps be promoted through tax, human capital, infrastructure, and capital markets policies, very much along the lines of traditional dual economy theories. From the perspective of economic growth, we should not expect much from the unofficial economy, and its millions of entrepreneurs, except to hope that it disappears over time."⁶⁰

58. SHLEIFER, at 34.

59. *Id.*, at 35.

60. *Id.*, at 36.

A key benefit of formalization, allegedly, is better access to formal legal institutions. A small number of studies have shown some relationship between the quality of legal institutions and the size of the informal economy. However, the measures relied upon to draw these conclusions are unreliable and inappropriate. For instance, La Porta and Schleifer use data based upon the number of steps needed to collect on a bounced check and the efficiency of the bankruptcy procedure.⁶¹ Microenterprises are not likely to accept checks for payment as they would have to have access to a mechanism to confirm check validity and to cash the check, which is challenging in developing countries. Enforcing bounced checks is likely to be associated with larger, formal firms. Bankruptcy procedures are also weak indicators of small firm access to courts. For a firm to declare bankruptcy it must have a corporate form of some sort, or the existence of a legal personality. A small informal business has no corporate form, and a small start-up company with little capital will likely operate as a legal person rather than a judicial (corporate) entity, so they would not likely take advantage of the bankruptcy system.

In sum, the competing views of informality can be perceived on a continuum. Dualism assumes no connection between informal and formal firms and recommends policies that focus on developing new small businesses rather than forcing informal firms to formalize. Structuralism sees informality as an offspring of haphazard capitalist development that pushed some firms away from the formal sector. Proponents of this view, including the state of Colombia, see a need to make formalization more accessible and also to increase enforcement of laws preventing unfair competition. And at the other extreme, legalism, or the “romantic view”, focuses exclusively on correcting institutional deficiencies that prevent informal firms from achieving their true growth potential.

61. *Id.*, at 8.

The approach to formalization that has developed through the work of Portes, Loayza, de Soto, and the World Bank, among others, has emphasized barriers to entry into the formal economy as the key obstacle to overcome. Very little analysis has been done on the question of why a second economic sector exists and continues to grow in the face of improvements in the regulatory structure of the state. This critical oversight has mistakenly assumed a demand for formalization that does not exist. Accordingly, formalization processes are likely to result in improvements in the formal business registration and taxation structure, but will have little if any impact on the size or growth of the informal economy.

Each of these views is based on a series of unreasonable assumptions about the internal dynamics of the informal economy. Informal firms have different motives, goals, and rationales for operating in this economic sector, none of which merit an assumption that they are driven toward increased productivity or formalization.

Illegal Work and Illegal Goods

It is worth spending a few moments discussing whether illegal goods and services, whether formal or informal, should be included in the scope of informal economic activity. In Hart's updated work, he makes it evident that the informal economy in his conception includes all unregulated work, both legal and illegal. Following this definition, illegal goods as well as illegal processes to obtain or produce licit goods would be counted as within the informal economy since they operate outside the regulatory structure of the state.

In Chen's analysis, illegal goods are considered a part of the informal economy, but a minimal part and one that should not be serve to discount the important legal goods and

services provided by informal workers and firms.⁶² Loayza explicitly excludes criminal activities from his analysis of the informal economy, focusing instead on undeclared non-criminal enterprises.⁶³ However, it should be noted that Loayza also excludes home-based work in his analysis, which diverges from the definition used in this thesis.

Illegal goods and processes constitute a portion of the marketplace that, while prominent in many contexts, have been intentionally excluded by several analysts.⁶⁴ The rationale for excluding illegal goods from the traditional informal economy definition is that these goods and services cannot legitimately become part of the formal economy. Thus, illegal narcotics, the child sex trade, and counterfeit currency, will remain illegal in a formal economy.

Illegal processes that produce licit goods, on the other hand, have a legitimate argument to be made that they should be included in the definition of the informal economy. In fact, selling goods as an unregistered merchant, occupying public space without a license, and failing to pay taxes and formal registration fees for your firm are all illegal activities; however, the resulting good or service – manufactured goods, consumer products, and domestic services, are in most cases licit and would be legal but for the failure to abide by the regulatory mechanisms of the state.

Accordingly, for our purposes, illegal goods and services trade, such as narcotics, intellectual property right infringing goods, and prostitution, will be excluded from the definition of the informal economy. But illegal processes that result in the production of licit goods and

62. CHEN, *Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment*, 4.

63. LOAYZA, et al., *The Impact of Regulation on Growth and Informality: Cross-Country Evidence* 129.

64. See, e.g., SCHNEIDER & ERNSTE, *The Shadow Economy: An International Survey* 12. (distinguishing between the “irregular” or informal sector and the criminal sector and finding that in the latter, not only is the production illegal, the output is also illegal, unlike in the informal sector where the output is legal).

services will be included in the definition of the informal economy.⁶⁵ Thus, all unregulated business activity that results in the production of licit goods or services constitute the informal economy.

What is the Problem with Informality?

States are motivated to formalize for a number of reasons. Formal firms pay taxes and adhere to laws and regulations that help the state to function and promote public safety; competition between formal and informal firms could lessen; and foreign investors may perceive a more hospitable investment climate. But central on the agenda of many policymakers is the potential increase in firm productivity.

Schneider argues that informality yields lower tax revenue for the state; distorts economic and social data that could affect the distribution of state benefits; lowers tax morality, which is highly associated with rule of law; creates unfair competition with the formal economy; increases dependence on welfare programs; reduces efficiency in production; leads to unregulated business activities that could put consumers at risk; and potentially worsens equality.⁶⁶ His global survey yields few observable positive benefits of maintaining a large informal economy other than basic employment at the subsistence wage.

Informal employment was largely tolerated for many years as a form of survival in the face of high unemployment rates in developing (and previously developed) countries. Only with the advent of increasing competition in the marketplace, driven mainly by the push for trade

65. See, e.g., CHEN, *Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment*, 14.

66. BAJADA & SCHNEIDER.

liberalization, has informality been characterized as a drag on economic development. Accordingly, many developing states that intend to become integrated into the global marketplace have taken on efforts to address informality. Each country approaches the informal economy differently—some focusing more heavily on social programs to protect workers, others adding resources to enforcement of registration laws—but most have begun the process of formalization.

Informality is also associated with low productivity. According to Friedrich Schneider, who conducted an extensive analysis of informality around the world, small firm size caused by a desire to avoid detection prevents otherwise productive enterprises from expanding their business and taking advantage of specialization and efficiencies gained by adding employees.⁶⁷ Using enterprise survey data, Maloney and Perry also suggest that there may be a negative correlation between firm productivity and informality. They assert that as firms become more productive, they are less likely to be informal.⁶⁸ Of course, as they recognize, this correlation may have little relation to the ability of the state to increase the productivity of existing informal firms and may instead relate to the firm's ability to shed its informal skin once it finds an avenue toward earning sufficient profit as a formal enterprise. Rather, this merely shows that firms that are formal are more productive than firms that are not, which is logical given the small size, inefficient operation, and limited resources of an informal firm.

Firm productivity has long been linked to economic growth. Increases in marginal productivity are generally measured by calculating the change in output gained from one additional unit of input (labor, land or capital). These changes can come from capital

67. SCHNEIDER & ERNSTE, *The Shadow Economy: An International Survey* 159-160.

68. PERRY, et al., at 160.

investments, technology, or from specialization and growth, for example. As a firm becomes more productive, it is able to increase its profits without changing the number of hours worked. For an informal firm to increase profits, it must generally operate for longer hours.

In Colombia, the principal case study of this thesis, firm productivity and formality are high priorities for the state. As Colombia rapidly integrates into the world economy by negotiating bilateral and regional trade agreements, lowering tariff levels, and changing laws to protect foreign investors, the informal economy has become a barrier to successful economic growth. Significant resources have been funneled into the resolution of this dilemma. For instance, the Colombian Ministry of Commerce, Industry and Tourism, at the forefront of trade development in Colombia, maintains an office of formalization. Within this office, economists work diligently to identify the areas in which formalization should be encouraged and review laws and policies that may make it more difficult for small firms to join the formal economy. In speaking with the coordinator of this office, I learned that the state is trying to promote formalization in an effort to increase the productivity and competitiveness of small firms in the face of growing trade.⁶⁹

The linkage between formalization and productivity appears weak, at best. After surveying a number of studies around Latin America, Perry and Maloney conclude that the empirical evidence suggesting a linkage between formalization and growth is quite limited. “The empirical evidence of aggregate negative growth effects of informality is not conclusive, as informality tends to lose significance when other standard growth determinants are controlled

69. KEVIN J. FANDL, Interview with Alexandra Diaz Montenegro, Formalization Coordinator, Vice Ministry of Business Development, Ministry of Commerce, Industry and Tourism (2009). (on file with author).

for.”⁷⁰ Yet they encourage states to continue their efforts to reduce regulatory burdens and streamline business development, arguing that these could reduce the size of the informal sector. But they cautiously suggest that this should not be the only, or even the primary approach for states.⁷¹

Working Definition of Informality

The informal economy in developing countries is vast and dynamic. Its scope ranges from fully informal street vendors completely disconnected from state services and regulation, to small firms struggling to survive with the hope of one day formalizing, to fully formal workers and firm owners taking on informal side jobs to make ends meet. To characterize the informal economy as a distinct entity, completely segregated from formal economic activity, misrepresents the critical role that informality plays in the development of a modern economy.

For our purposes, and limiting the application to commercial enterprises, the informal economy includes all unlicensed business endeavors that result in the production of licit goods or services for public sale and consumption. Illegal goods and services are explicitly excluded from this definition, as are workers that produce only for their own consumption (e.g., non-market fisherman and farmers).

It should be reiterated here that while all unregulated and unprotected industries producing licit goods or services might be considered part of the informal economy, the reverse is not necessarily true. Many firms skirt tax laws to cut costs but comply with state licensing

70. PERRY, et al., at 175.

71. Id. at 176.

requirements, or provide requisite worker benefits and salaries without registering those workers. According to Tokman, “depending on the economic activity, only a fraction of all microenterprises find themselves operating under fully illegal conditions with respect to taxes and operating licenses.”⁷² This poses a significant problem for data collection and comprehensive analysis since some firms could be considered informal when they abide by labor and tax laws but fail to secure registration documentation from the Chamber of Commerce, whereas others might appear formal on paper but lack any interest in adhering to applicable regulations.

Conclusion

A recent book by United Nations University scholars Basudeb Guha-Khasnobis, Ravi Kanbur, and Elinor Ostrom, explores the complexity of the concept of informality and argues that the use of the formal-informal dichotomy may be less helpful for policymakers than theorists believe.

Given the prominence of the formal-informal dichotomy in the development discourse, one might expect to see a clear definition of the concepts, consistently applied across the whole range of theoretical, empirical, and policy analyses. We find no such thing. Instead, it turns out that formal and informal are better thought of as metaphors that conjure up a mental picture of whatever the user has in mind at that particular time.⁷³

72. TOKMAN & KLEIN, Regulation and the Informal Economy: Microenterprises in Chile, Ecuador, and Jamaica 102.

73. BASUDEB GUHA-KHASNOBIS, et al., Linking the Formal and Informal Economy: Concepts and Policies 2-3 (Oxford. 2006).

What is clear, however, is that policymakers and multilateral institutions have capitalized on the concept of an informal economy to design economic policies and laws. Whether their strategy is to increase firm productivity, provide social protection for the poor, or improve tax collection, states are determined to rid their cities of unlicensed vendors, unregulated shops, and unmonitored services.

The strategies that states develop to achieve this goal are the focus of this thesis. I attempted to identify a baseline definition of the informal economy in this chapter, but it should be noted that each state adheres to its own variation of this definition. In Colombia, for instance, an informal firm is defined by the state as one that is not registered with the Chamber of Commerce, a private entity, and that does not pay taxes. As discussed above, this definition could include some semi-formal firms and exclude some informal firms. However, for the purposes of analyzing policy and legal developments related to the broader informal economy, some imprecision may be acceptable.

The informal economy is home to the most unstable and likely the least profitable business endeavors, and to a mix of industries and work ethics. No matter how it is characterized, informal firms are engaged in a fight for their own survival. Formalizing these businesses may turn them into profitable ventures, or it may destroy their way of life and their only hope for survival, pushing their owners deeper into poverty. As states and multilateral institutions continue to pursue formalization as a mechanism to achieve economic growth, it is imperative that a thorough analysis of the impact of formalization on firms be conducted to ensure that resources are properly allocated and that firm promotion, rather than destruction, is the ultimate result.

Chapter 2: Globalization and the Informal Economy

The informal economy, as explained above, impacts competition within the formal marketplace by undercutting formal firms that are obligated to pay taxes and fees, comply with labor and trade regulations, and pay higher prices for business services than an individual would have to pay. This creates not only frustration within the formal economy as formal firms lose business to unfair competition by informal firms, but also limits the ability of formal firms to compete with foreign firms that operate more efficiently and often with access to lower cost inputs. Trade liberalization within many developing countries has opened the door to foreign investors that, with the help of attractive investment provisions and protection of the foreign state, open their highly competitive firm alongside the domestic firm, already struggling to survive in the face of high informality. The impact of globalization combined with an expanding informal economy has led to a difficult environment for formal businesses in developing countries, and in some cases, perverse incentives for the government to encourage formalization.

A second key relationship between trade liberalization and the informal economy is the impact of open markets on the microenterprise sector. A small firm with limited capital resources, limited experience, and a small market share, may find foreign competition particularly deadly. A local hardware store will find survival increasingly difficult in the face of increasing market share for corporations such as Home Depot. A local grocery store may find competition by Carrefour impossible to overcome. And most small textile, electronic, and other

consumables vendors will find investment by large firms such as Walmart insurmountable. The U.S. experience has shown that microenterprise can be the driving force of a successful economy. However, with an undeveloped support system in most developing country states, little opportunity for capitalization, and rigid and complex formalization systems that leave many microenterprises in the informal economy, the developing country microenterprise sector is increasingly at risk.

In this chapter, I will explain the relationship of increasing trade liberalization in developing countries with competition in the domestic marketplace, focusing specifically on the impact of trade liberalization on informality. I will go on to discuss the role played by domestic law and policy in the protection of the domestic market, considering the impact of trade facilitation and formalization on the stability of the domestic market.

Trade Liberalization in Latin America

Developed countries have pursued trade liberalization amongst their trading partners in earnest since 1934, when the United States passed the Reciprocal Trade Agreements Act, which granted then President Roosevelt to negotiate mutual tariff reductions with trading partners, mostly in Latin America. The formation of the General Agreement on Tariffs and Trade (GATT) thirteen years later sealed the global ambition to lower trade barriers in an effort to promote a peaceful and prosperous world economy from the ashes of World War II.

The vast majority⁷⁴ of countries that partook in the negotiations at Bretton Woods in 1944 that formed the International Monetary Fund and the International Bank for Reconstruction and Development (the World Bank today) and the GATT in 1947 hailed from the developed world. Developing countries at the time played a miniscule role in trade, or did so as colonies of developed countries, and thus had practically no voice in the development of the world trade system as it came into existence in the 1940s. However, this changed in the 1960s with the formation of the United Nations Conference on Trade and Development (UNCTAD) and the subsequent addition of Part IV to the GATT, including the enabling clause.

As developing countries facilitated the development of their national economies and disconnected from their colonial masters, they became more important players in world trade. However, they were seen as outsiders to the main trade process, led by developed countries. They were left out of major trade negotiations, excluded from most major agreements reached in world trade rounds, and largely ignored when they sought concessions beneficial to their interests. Maintaining this distinct class of countries, yet recognizing their unique needs, GATT parties agreed to Part IV of the GATT, which allowed developed countries to treat developing countries with certain preferences that would otherwise be contrary to the central GATT principle of Most Favored Nation status, which requires a benefit given to one country to be given to all parties to the agreement. Although this “special and differential treatment” provision offered protection to developing countries in the form of preferential access to

74. The original contracting parties to the General Agreement on Tariffs and Trade were Australia, Belgium, Brazil, Burma, Canada, Ceylon, Chile, China, Cuba, the Czechoslovak Republic, France, India, Lebanon, Luxembourg, Netherlands, New Zealand, Norway, Pakistan, Southern Rhodesia, Syria, South Africa, the United Kingdom, and the United States.

developed country markets with little or no reciprocation, it also solidified their position as outsiders in the world trade process.

Most developing countries in Latin America maintained high tariffs and quotas against imports through the 1980s following the economic theory of Raul Prebisch that encouraged countries to levy high taxes against imports in order to direct national resources toward the development of domestic industries, which were highly uncompetitive at the time. Once industries became more competitive, these barriers could be lowered and the country could open their doors to imports once again. This *import substitution* approach produced reasonable levels of growth, but limited the potential of most developing countries to take advantage of rapid economic growth in the world economy. In the latter part of the decade, most developing countries shed their *import substitution* policies in exchange for some limited trade liberalization.

Some developing countries, in particular Brazil, India and China, enjoyed significant rates of return on key exports, such as oil, steel, and manufactured goods. Their economies grew at impressive rates, well above global averages, thus propelling them into the league of major trading countries. Yet rather than moving from one team to the other, as developed countries had hoped, these countries led the push for more reasonable trade policies that opened the door to key exports from developing countries and that limited the potential for developed countries to overrun developing country markets with competing goods. Beginning with the 1999 World Trade Organization meeting in Seattle, developing countries began to group together to object to unfair trade practices. Thus began a new era in trade in which developing countries could no longer be ignored.

Developing countries today face a particularly intractable problem – if they close their doors to trade, they risk losing foreign investment that yields significant gains from taxes, labor, and technology transfer in some cases. Yet if they reduce their trade barriers, they risk allowing in more efficient producers that can push small domestic industries into unemployment or, in many cases, into informality.

Trade liberalization is often considered to be beneficial in the aggregate to trading countries. Inefficient producers will be replaced by more efficient producers, thereby lowering the cost of goods for consumers and allowing them to reinvest more capital into their markets. There will be winners and losers, but on the whole, there will be a net gain, the argument goes. However, in the case of trade between developed and developing countries, the losses are often weighted heavily in the developing world, where unemployment and inequality have increased since liberalization in this part of the world began in the 1990s. Despite this fact, developing countries are scrambling to be included in the liberalization process, entering bilateral and regional trade agreements with partners such as the United States and the European Union in an effort to secure additional market access for their export firms and opening the door to imports demanded by their upper class citizens.

Whether trade liberalization on the whole is beneficial to developing countries is beyond the scope of this thesis.⁷⁵ The key point for my analysis here is that trade liberalization in Latin America places the state in the difficult position of balancing the potential for increased

75. For further discussion, see, e.g., KEVIN J. FANDL, *U.S. Trade Policy and Multilateralism - The Challenge of Bilateral Trade Agreements*, Virginia Bar Journal (2007); KEVIN J. FANDL, *Making Trade Liberalization Work for the Poor: Trade Law and the Informal Economy in Colombia*, 43 Texas International Law Journal (2008).

foreign investment and market access with the high risk of increasing unemployment and loss of small industries.

The Relationship between Trade Liberalization and Informality in Latin America

Informality is often evident in countries in which significant surpluses of labor exist. This tends to increase reliance on labor-intensive industries, such as commodity extraction, agriculture, and services. These tend to be the sectors most often flooded with informal workers and firms. Surplus labor in these segments of the economy can be attractive to foreign firms looking to cut costs by setting-up manufacturing and production plants in these states. Some foreign firms are motivated to capitalize on this cheap labor and low-cost intermediate goods; however, this tends to be localized in countries with very large informal economies and sufficient surplus labor markets.

It is not entirely clear what motivated foreign firms to invest in countries with respect to the size of their informal economy. Evidence suggests that some firms prefer larger informal economies in order to capitalize on lower labor and intermediate good costs. Other evidence suggests that firms seeking more than cheap labor costs – that is, domestic market integration, product development and marketing, or innovation – prefer smaller informal economies in order to reduce unfair competition and risks to property rights. The latter firms tend to have a more positive impact on the developing country economy as they yield greater tax benefits for the state, employ more domestic workers applying accepted labor standards, and train more skilled labor that can be transferred between firms. Accordingly, governments that intend to

create sustainable, long-term benefits from trade openness would be remiss to emphasize the attractiveness of their large informal economy.

Recent research by Sugata Marjit and Dibyendu Maiti at the Center for Studies in Social Science (Calcutta) and the Center for Development Studies, respectively, shows that the informal sector comprises as much as 70–80% of the economy in many developing countries, and as much as 90% if agriculture is taken into consideration.⁷⁶ The goods and services produced in this sector are vertically linked to goods and services in the formal sector.⁷⁷ This important finding corrects prior studies of this sector which showed a minimal relationship.⁷⁸ Markets are either local, national, or export (international), according to Marjit and Maiti.⁷⁹ Informal workers generally cannot participate beyond the local market unless they utilize middlemen or traders to carry their goods to those broader markets. When they do, the middlemen extract a portion of the profit from the good.⁸⁰ “If the artisans wish to avail themselves of the external markets, they become tied to master enterprises (the formal producers) and traders.”⁸¹ The authors contend that deregulation is the most effective approach to improve the conditions of informal workers. Echoing these sentiments, Anne Trebilcock argues that “while some informal workers provide low-cost inputs to global

76. SUGATA MARJIT & DIBYENDU S. MAITI, *Globalization, Reform and the Informal Sector* WIDER Research Paper No. 2005/12, 2005 at http://www.wider.unu.edu/publications/working-papers/research-papers/2005/en_GB/rp2005-12.

77. For instance, many foodstuffs sold by informal vendors are name brand products that were purchased, directly or indirectly, from major manufacturers. See Id.

78. Id.

79. Id.

80. Id.

81. Id.

production systems, the majority are excluded from the opportunities of globalization and confined to restricted markets.”⁸²

Pinelopi Goldberg and Nina Pavcnik wrote a particularly insightful paper discussing the effects of trade liberalization on the informal sector in Latin America. They conclude that while there is no such linkage in Brazil, there was a linkage in Colombia before the completion of major labor market reforms in the 1990s.⁸³ They begin by pointing out the dearth of evidence supporting the relationship between informal employment and trade policy.⁸⁴ The authors question the traditional hypothesis that as competition increases, firms are more likely to resort to subcontractors and other informal workers to cut costs.⁸⁵ They contend that if this were true, firms would have done this long before the increase in competition (perhaps stringent labor laws prevented firing such workers).⁸⁶

The authors focused on Colombia and Brazil due to their recent major labor market reforms and large informal sectors.⁸⁷ Colombia reduced its trade barriers between 1984 and 1994, with the largest reforms taking place in 1990 and 1991.⁸⁸ Between 1984 and 1998, the average tariff in Colombia declined from 27% to 10% (an aggregate measure that does not accurately reflect the tariff on goods produced directly or indirectly by the informal sector).⁸⁹

82. INTERNATIONAL LABOUR ORGANISATION, *World Commission on the Social Dimension of Globalization, A Fair Globalization: Creating Opportunities for All* 60 at <http://www.ilo.org/public/english/wcsdg/docs/report.pdf>.

83. PINELOPI K. GOLDBERG & NINA PAVCNIK, *The Response of the Informal Sector to Trade Liberalization*, Nat'l Bureau of Econ. Research, Working Paper (2003).

84. *Id.* at 2.

85. *Id.* at 3.

86. *Id.*

87. *Id.* at 4.

88. *Id.* at 13.

89. *Id.* at 13.

The authors found that informal workers in Colombia tend to be older, less educated males,⁹⁰ a finding that contradicts many of the reports on this economy. The primary industries in which these authors find informal workers employed in Colombia are in the “manufacture of wood and wood products, agriculture, restaurants and hotels, and household services.”⁹¹ Goldberg and Pavcnik conclude that labor market institutions are critical when analyzing the effects of trade policy on employment.⁹² When operating in rigid labor markets, firms are more likely to respond to increased foreign competition by reducing formal employment.

Anne Trebilcock, Deputy Director of Policy Integration at the International Labor Organisation (ILO), provided a comprehensive summary of the 2002 international labor conference in which the issue of informal work arose. The ILO recognized at this session the important contributions that informal work makes to the global provision of goods and services.⁹³ Speaking about the informal workers, the ILO found that “although they are operating within the formal reach of the law, the law is not applied or not enforced; or the law discourages compliance because it is inappropriate, burdensome or imposes excessive costs.”⁹⁴ Because linkages exist between formal and informal work, the ILO set forth several recommendations for the betterment of the informal economy.

Importantly, the ILO recognized that the elimination of the informal economy is not a reasonable or desirable goal. Rather, it suggested removing the negative aspects of the informal economy while ensuring the protection of the opportunities for entrepreneurialism and

90. Id. at 18.

91. Id. at 24.

92. Id. at 30.

93. ANNE TREBILCOCK, *Decent Work and the Informal Economy*, World Inst. for Dev. Econ. Research (2005).

94. Id. at 2.

livelihood that informal work provides.⁹⁵ This protection specifically includes the right to decent work and social security coverage. While not directly linked with poverty, working informally does indicate income variability and instability.⁹⁶

According to the report, bad macroeconomic and social policies are often at the root of expanding informal economies.⁹⁷ These factors include the lack of a good legal and institutional framework, good governance, and the proper implementation of laws and policies. In particular, the report suggests enacting legislation governing employment relationships, enforcement of rights and protections, easy access to legal dispute resolution mechanisms, lower costs of establishing new businesses, and laws that protect property rights and title assets.⁹⁸ To promote these interests, the ILO suggests the protection of freedom of association, including the proliferation of business associations to protect the rights of informal workers.⁹⁹

In 2009, the ILO, recognizing the strong link between informality and trade, joined forces with the World Trade Organization (WTO) to issue a report entitled, “Globalization and Informal Jobs in Developing Countries”.¹⁰⁰ The report examines the relationship between trade liberalization and informal sector growth, noting that the evidence has shown mixed results. Traditional trade theory suggests that increased openness to international trade will create jobs in host country markets, thereby incentivizing informal workers and firms to transition into formal positions that offer better wages and stability. Yet the report opens with the assertion that this theory has not materialized in practice—“[i]n many developing economies job creation

95. Id. at 3–4.

96. Id. at 6.

97. Id. at 8.

98. Id. at 8.

99. Id. at 12.

100. Globalization and Informal Jobs in Developing Countries. (2009).

has mainly taken place in the informal economy.”¹⁰¹ This unexpected result is the focal point of the joint ILO/WTO study.

Using data from the International Institute of Labor Studies, the report authors show that countries that have opened their markets to increased international competition have experienced increases in their informal markets. For instance, China’s informal economy in 1990 was estimated at 78.3%, while its 2003 estimate is 85.9%, a massive aggregate increase. Colombia’s informal economy hovered around 54% at the onset of trade reforms, while today it is estimated to account for around 58% of the total economy. Yet there are exceptions, such as Chile, which reduced its informal economy from 40.5% in 1990 to 32.3% in 2003, crediting the conclusion that domestic market reforms must accompany trade liberalization.

The report authors emphasize the need to coordinate domestic reforms with trade liberalization programs, noting that only a few countries have successfully reduced their informal economies in the face of trade opening. They warn that trade liberalization may actually impact development of functioning economies by channeling resources into low-skilled labor industries and the provision of cheap intermediate goods and services for the benefit of foreign firms. This exploitation of the informal economy is apparent in countries such as China, where foreign firms have been known to leverage cheap labor inputs to produce high-end exports for developed country markets.

Do large informal economies, then, serve as catalysts for foreign investment by firms looking to exploit cheap labor and intermediate goods? According to the ILO/WTO report authors, some countries market their abundant and cheap labor markets as grounds to relocate manufacturing or production operations in their country. As long as basic infrastructure and

101. Id.

attractive finance regimes are in place, an informal marketplace can be a playground for foreign investors looking to cut costs.

International trade reforms can have a substantial, negative impact on the labor market in a developing country. Dani Rodrik finds that global trade favors capital-intensive as opposed to labor-intensive industries, placing most developing countries with their labor-intensive economies at a significant disadvantage.¹⁰² Additionally, trade liberalization often has the effect of increasing competition in the domestic marketplace. As demand for labor decreases, informal workers proliferate and the number of workers with unstable and generally lower-paying positions increases:

[G]lobal competition tends to encourage formal firms to shift formal wage workers to informal employment arrangements without minimum wages, assured work, or benefits and to encourage informal units to shift workers from semi-permanent contracts without minimum wages or benefits to piece-rate or casual work arrangements without either assured work, minimum wages, or benefits.¹⁰³

The ILO/WTO report authors conclude with the mantra of Dani Rodrik—“policies matter.” Getting the domestic policies right appears to be a preliminary requirement before countries engage in trade liberalization. This means that appropriate laws and policies need to be in place to incentivize formalization when the conditions are right, stimulate small business entrepreneurship, protect workers from abuse and exploitation by domestic or foreign firms, and secure the property of domestic workers and firms. The ILO/WTO report authors argue that, “regulatory and administrative changes that bear no budgetary costs for policymakers”

102. MARILYN CARR & MARTHA ALTER CHEN, *Globalization and the Informal Economy: How Global Trade and Investment Impact on the Working Poor*, International Labour Organisation (2001). at 2.

103. *Id.* at 3.

such as “reducing red tape and lowering the burden of taxation” are the best mechanisms to prepare an economy for trade openness.¹⁰⁴

The report authors examine the three principal schools of thought surrounding informal economy reform—structuralism, legalism, and dualism. The ILO tends to follow the structuralist approach, which promotes an expansion of labor and business laws and the protection of private property for informal firms, improved labor inspections, increased dialogue with organizational representatives (unions, cooperatives), promotion of decent working conditions and gender equality, facilitating of entrepreneurship, improved access to social security, and localized strategies for reform.

The legalist view, initially proposed by de Soto and recently highlighted by Perry, suggests that formalization is simply one input in the production process and that most small firms do not need it to function effectively. This perspective sees informality as a rational choice by the firm, which is attempting to capitalize on its extralegal operations. In order to incentivize firms from this approach, Perry suggests administrative and tax simplification procedures, eliminating anachronistic or privately motivated laws, and enhancing enforcement. The legalist view perceives barriers to formalization within the formal legal structure of the state and argues that if these barriers are lowered, more firms will be incentivized to become formal.

Finally, the report authors highlight the dualist view often promoted by Tokman and recently highlighted in a paper by the World Bank’s La Porta and Schleifer. This view draws a clear line between formal and informal firms and makes no secret of the contention that formalization is a waste of resources. In their view, informal firms are not entrepreneurs, nor are they prevented from formalizing by a complex legal regime. Rather, they are survivalist

104. Globalization and Informal Jobs in Developing Countries. (2009).

firms in need of basic social services from the state to prevent them from slipping deeper into poverty. The remedy for informality in the dualist approach is expansion of the formal sector through productivity incentives such as improved tax regimes, human capital development, and infrastructure.

The authors of the ILO/WTO report conclude that the best strategy combines factors from each of the approaches listed above. My experience suggests that a single approach will be ineffective as most informal economies are diverse and include firms and workers that lack access to adequate labor and regulatory protections, those that elect to reap the benefits of extralegal activity while they can, and those that are relying on informality as the only option for sustainable income. Accordingly, any public policy that attempts to conform its entire informal economy into a single rationale is likely to be met with resistance and failure.

The Impact of Trade Liberalization on the Domestic Developing Country Economy

Trade liberalization is likely to have two significant effects on the informal economy in Latin America. It will cause many microenterprises to lose market share and possibly terminate operations; and it will encourage more formal domestic firms to utilize informal labor as a means of reducing operating costs. Each of these outcomes will reduce the competitiveness of the developing country on global markets, replacing domestic firms with foreign firms and reducing export capacity.

Because developing countries have largely been devoid of foreign investment since the rise of the multinational corporation, microenterprises constitute the vast majority of firms in most developing countries. In general, a few multinational enterprises control the export

economy and most of the gains from international trade; however, small businesses keep the majority of the working population employed and sustain the livelihood of the population.

Not all microenterprises are informal; however, estimates in countries such as Colombia suggest that the majority of small businesses are unregistered with the chamber of commerce and those that are registered may not be complying with labor and tax laws and regulations. Accordingly, any impact on the microenterprise sector will affect large segments of the informal economy.

Trade liberalization is not intended to benefit microenterprises. Rather, it is meant to increase opportunity for exports, driven primarily by only a handful of corporations in developing countries, and to reduce the cost of consumer goods, which is only valuable if consumers maintain sufficient income to purchase consumables. Microenterprises provide sustainable income for individuals in developing countries and allow them to participate in the formal marketplace as consumers.

Reduced or eliminated trade barriers will permit foreign corporations easier access to domestic markets by lowering the final cost of their goods. The reduction or elimination of tariffs on imports will give foreign firms an improved position in the domestic market and may allow them to solidify their control of the market by eliminating domestic competition. The ultimate benefit to the domestic market will be lower priced consumer goods and inputs into manufactures. However, these benefits may be outweighed by the loss of domestic microenterprises, potentially leading to higher unemployment.

Trade and Formalization

A developing country that chooses to liberalize its economy and open its doors to increased foreign investment and competition while simultaneously initiating a formalization process risks not only destroying the domestic formal economy, but also pushing informal laborers into unemployment.

There appear to be two models of foreign investment in developing countries with respect to the informal economy. Companies interested in cutting production costs may turn to foreign markets where they can capitalize on lower labor and intermediate good costs. These firms may have little interest in contributing to local economic development or transferring technology to the host country. Rather, they take the traditional Ricardian approach of soliciting low-cost inputs wherever they can be found. Countries that wish to attract this type of foreign investment may establish export-processing zones or other legal mechanisms aimed at attracting investors for this limited purpose with little noticeable benefit to the domestic economy.

The second model includes companies that intend to develop a product or service for domestic consumption in the host country, transfer technology to that country in an effort to establish long-term operations there, or utilize domestic resources other than labor alone to improve their firm's productivity. Countries that wish to attract this type of foreign investment may use tax incentives, chambers of commerce, and diplomatic relations (such as bilateral trade negotiations) to stimulate investment, which may ultimately outweigh any benefits gained from the foreign investment. The goal of this type of investment is long-term, sustainable gains from trade.

Both models can create benefits for host countries. The labor model mentioned first generates demand for informal production and may lead to some limited skills training. However, the gains for the state will be minimal as economic incentives will be necessary to attract companies searching for productivity savings. The cooperative model mentioned second has less demand for informal labor for a variety of reasons, including global ethical responsibility to maintain high labor standards, adherence to local laws, and public image preservation. The gains for the state here are more significant as formal labor will be taxed along with the foreign firm, investments in capital equipment and technology are likely for the growth of the foreign firm, and formal supply firms may be stimulated by the establishment of a formal foreign firm.

The choice of investment model will influence the demand for formalization in the developing country. The labor model benefits from informality as it helps firms skirt high labor costs and regulation. Countries seeking this type of investment will be motivated to restrain enforcement against informal economic activity. The cooperative model suffers from high informality as it threatens unfair competition and the weakening of property rights and rule of law. Countries seeking this type of investment will be motivated to increase enforcement against informal firms and firms employing informal workers. The choice of a model for attracting foreign investment can substantially impact the trajectory of economic development within any given country. While the labor model promises short-term gains, the cooperative model positions a country for sustainable growth.

Chapter 3: The Response to Informality

Introduction

The informal economy has become a scapegoat for international institutions and liberalizing states to fight against high taxes, overregulation and weak law enforcement. The World Bank, the Inter-American Development Bank, the McKinsey Global Institute, the Cato Institute,¹⁰⁵ and other pro-business organizations, argue that formalization is a necessary process if a country wants to improve economic growth through modern commerce. Their strong support for formalization has led many developing states to pursue formalization policies that appear unlikely to yield significant economic growth gains, and may in fact be detrimental to their economic success.

While the formalization process around the world is not homogenous, several general characteristics support the idea that formalization will benefit economic growth. Among these, firms are encouraged to seek state licensing and registration, pay taxes, adhere to industry-specific health, safety, and operational regulations, and comply with the law by selling only licit and licitly obtained goods or services. Once a firm completes the state-specific requirements to formalize their business, they become a member of the formal economy. Once formal, they are expected to receive access to all the rights and privileges of a formal firm, including access to credit, skills training and development, access to financial resources, and opportunities to

105. See, e.g., ENRIQUE GHERSI, *The Informal Economy in Latin America*, 17 Cato Journal.

become a productive member of the economic community through networking, marketing, and contact with like-minded firms. From an entrepreneurial model perspective, like that offered by de Soto, this is an appealing proposition for a state; a small contribution of resources to the informal economy and some streamlining in small business rules and regulations in exchange for an army of productive firms that launch the state's economic development to new levels.

Unfortunately, this does not seem to be the result in practice.

In my study, I have identified four flawed assumptions upon which formalization policy is based. First, the policy assumes that the developing state has a single legal and economic framework within which firms operate, rather than an inter-connected dual system of rules and processes. Second, the policy incorrectly assumes that economic and regulatory barriers are the main cause of a large and growing informal economy. Third, the policy incorrectly assumes that the informal economy is homogenous and that operating in the formal economy is the goal of all firms. And finally, the policy assumes that informal firms that formalize will become productive and contribute to the economic growth of the state if they formalize, which the evidence does not support. I will introduce each of these assumptions below and then go on to discuss them in greater detail in the forthcoming chapters.

Multiple Legal and Economic Frameworks

The concept of rule of law historically supports the concept of a single legal framework within which a citizenry and a market will operate. The sovereign stands at the heart of that single framework, disseminating rules and enforcing those rules through judicial process and force. Individuals or firms that attempt to deviate from the single legal framework are

penalized. Following this logic, a large informal economy might be perceived as a threat to state control as it provides an alternative livelihood for a significant number of individuals and firms that choose to deviate from the single legal framework. If the state is unable to convert these informal practices into the formal conduct of business, the state will lose control over its population and the economic resources upon which it survives.

Yet what traditional rule of law theory ignores, or perhaps has forgotten, is the fact that rule of law was designed to protect the interests of a certain group of people – those with property that could be infringed upon by the state – and that there has always been a second group of people that have little or no property and thus operate outside the sovereign’s single legal framework. Marx and Engels considered this dual framework when they discussed the bourgeoisie and proletariat classes, the former having a significant need for state protection and rule of law and the latter depending on informal rules and processes to survive.¹⁰⁶ Informal economy scholar Saskia Sassen expanded upon Marx and Engels’ work by identifying capitalist development as the basis for the informalization of the state, expanding the gap between the propertied and poor classes.¹⁰⁷

The economic polarization that these scholars illuminate can also be associated with rule of law polarization. The laws and regulations that form the basis for economic activity by reducing risks and transaction costs are not limited to one sector of the economy. Following Douglass North’s contribution to institutional economics, we might surmise that both formal and informal legal institutions support economic activity within a state.¹⁰⁸ Judicial process and

106. See, e.g., KARL MARX & FRIEDRICH ENGELS, *The Communist Manifesto* (1888).

107. SASKIA SASSEN, *The Informal Economy: Between New Developments and Old Regulations*, 103 *Yale Law Journal*, 2294 (1994).

108. See, e.g., NORTH.

state laws and regulations form the formal rule of law framework, and informal norms and alternative legal institutions form the informal rule of law framework. It is the informal rule of law framework and its associated legal institutions that reduce risk and facilitate economic activity in the informal economy.

Many informal firms do not perceive formalization as a goal. They exist within a functioning informal legal framework that effectively substitutes for what the state has failed to provide. Formalization policies that presume a strong demand for formal law fail to recognize the strong informal legal networks already in place in most informal economies. The demand for formal law may in fact be much less than states and development organizations realize, especially when it is associated with increased costs of doing business.

There is a growing push from development institutions and pro-business organizations to encourage states to reject any thought of a dual legal and economic framework and instead focus on transitioning informal firms into legality. Not only are informal firms largely uninterested in forming this relationship with the state; these firms have developed a business culture by which they sustain themselves on the gaps in the law, weak law enforcement, and a large community of like-minded businesses. This business culture exists side by side with the formal economy and is intricately linked to the economic foundation of the state.

The indirect costs of becoming formal, such as losing a competitive edge in the marketplace, abandoning flexible hours and location to operate a business, and being unable to deal in illicitly obtained goods, are too high for most informal firms to manage. And regardless of how explicit the law is in rejecting this type of behavior, these firms will continue to avoid compliance while it remains in their interest to do so. A recent study by rule of law scholars Katarina Pistor and Christopher Wellons suggests that the supply of law is irrelevant as

compared to demand for law: “However effective the legal system may be at performing market-supporting functions, actors can be expected to opt out of the legal system whenever nonlegal alternatives are available at lower economic or social cost to them.”¹⁰⁹

Thus, it appears to be not only the lack of interest in bargaining with the state, but also the alternative economic and legal operational environment maintained by the informal economy that drives its continued existence. The OECD noted this dilemma in reference to Africa, where trust in the state is very weak:

In many developing countries, the social order is predominantly shaped by informal agreements that are not written on paper, but exist outside of formal laws and regulations. As the South Africa example shows, such situations must not be disadvantageous and can sometimes even promote a country’s development. Village associations that are solely based on trust and peer pressure provide access to credit and insurance, help in times of distress, and facilitate the construction of public roads and sewage systems. The rapid expansion of community-based health insurance schemes all over Africa provides a good example.¹¹⁰

Throughout the developing world, informal legal institutions often serve as an effective, if unstable, alternative to formal justice.¹¹¹ The concern over formalization is exacerbated by the state’s ignorance of these institutions and their potential role in aligning both economic sectors toward comprehensive economic growth. The very existence of these institutions confirms the viability of a dual economic structure.

The formalization process attempts to convince firms that exist within this alternative legal and economic framework to abandon that framework in exchange for one offered by a

109. KATARINA PISTOR & CURTIS J. MILHAUPT, *Law and Capitalism: What Corporate Crises Reveal about legal Systems and Economic Development Around the World* 41 (2008).

110. *Informal Institutions: An Emerging Topic*. (2007).

111. KEVIN J. FANDL, *The Role of Informal Legal Institutions in Economic Development* 32 *Fordham International Law Journal* (2008). See also ETHAN BUENO DE MESQUITA & MATTHEW STEPHENSON, *Legal Institutions and Informal Networks*, 18 *Journal of Theoretical Politics* (2006).

distrusted partner – the state. Incentives to do so would have to be substantial to convince the firm to make this bargain. Rule of law guides the decisions of the propertied citizens in a state, while those with little or no property resort to alternative economic and legal institutions based upon rules and norms that do not depend on formal law or economic institutions. As such, formalization expends resources attempting to extract firms from the framework that serves as the foundation to their operations, and transplant these firms into an unfamiliar and untrusted framework. This approach has met with little success.

Barriers to Formalization

The McKinsey Institute, among other economic development policy organizations, consistently blames high taxation and overregulation for the existence of a large informal economy.¹¹² The Director of the McKinsey Global Institute, Diana Farrell, argues that informality results from and is facilitated by excessive tax burdens and the high cost of doing business. She argues that the only way to prevent rising informality and to promote business is to lower and simplify taxes and increase enforcement of existing laws against those firms that operate outside the formal sector.

But the average informal firm only survives by rejecting the rule of law and by earning profits based upon its unregulated activities. High taxes and complicated regulations can act as disincentives to the formation of a small, formal business. The informal economy largely

112. DIANA FARRELL, *The Hidden Dangers of the Informal Economy*, 3 McKinsey Quarterly (2006). (blaming high taxes and red tape, weak enforcement, and social norms for the high incidence of informality); DIANA FARRELL, *Tackling the Informal Economy*, BusinessWeek (2006). (arguing that tax amnesties contribute to growing informality).

consists of low skilled, limited resource, and often property-less individuals looking for income to meet their basic needs. High taxes and overregulation are much less significant to informal firms than access to legal institutions, education, and avoiding harassment by law enforcement and tax officials. Informal firms see little benefit in operating as a registered business regardless of the tax and regulatory structure.

While formalization may offer some short-term benefits, such as avoidance of tax collectors and law enforcement harassment, few informal firms see a benefit in long-term formal operation. The oft promised benefits of access to credit and increased growth opportunities through marketing and training mean little to an owner-operator without property to protect and with little trust in the state's promise of support. And although evidence suggests that formal firms are economically more successful than informal firms,¹¹³ no evidence supports the idea that informal firms become more productive when they formalize. Without these success stories, there is even less motivation to formalize.

In fact, some evidence suggests that formalization may be detrimental to an informal firm in the short run. Formalization means added costs of doing business, including registration with the chamber of commerce or other state entity, licensing fees, certification of their product, if necessary, rental of space or equipment for the business rather than working in public space, and the payment of taxes. All of these costs make the informal firm less competitive and dramatically reduce the likelihood of their survival. Already operating on the margin of profitability, informal firms do not want to compromise their fragile success.

A recent report on formalization by the U.S. Agency for International Development argues that, while little evidence supports the alleged connection between formalization and

113. SHLEIFER.

economic growth, there is a broader concern over the weakening social contract in countries with growing informal economies.¹¹⁴ However, their recommendations do not attend to this concern over the social contract but, like most other studies, focus on reducing tax and regulatory barriers to formalization and educating informal firms on the benefits of formalization.¹¹⁵

Streamlining business registration processes, providing tax incentives for new businesses, and making the conduct of business easier will undoubtedly have positive effects on the business environment. New businesses that otherwise would have been unable to operate formally may seek legal formation in light of improvements in these areas. However, there is little evidence to suggest that these changes have any impact on the size or growth of the informal economy.

The Heterogeneous Informal Economy

A firm might decide to avoid formality for a number of reasons, including the need for flexible working hours, lack of fixed location from which to operate, market demand, skill set, activities of friends and family, and perhaps most importantly, the ability to earn a profit. Given these criteria, two types of firms occupy the informal economy – those that would like to transition into the formal economy once they have sufficient resources or knowledge, and those that want merely to generate sustainable income by capitalizing on the advantages of operating informally. The latter category makes up the vast majority of informal firms.

114. Removing Barriers to Formalization: The Case for Reform and Emerging Best Practice. (2005).

115. See Id.

The internal duality of the informal economy is supported by many recent studies. In the World Bank report on informality, *Informality: Exit and Exclusion*, for instance, the authors differentiate between firms that determine that the benefits of operating informally outweigh those of joining the formal economy, and those that would prefer operating formally but for the high costs to entry.¹¹⁶ Gary Fields further divides up the informal economy into those workers that choose to operate informally to earn a profit by skirting the law and those that operate informally as a survival mechanism or as a second income.¹¹⁷

In all cases, informal firms make a rational choice to operate outside the legal and regulatory structure of the state. These firms are acutely aware that their activities violate the law, yet their motivation is not to skirt the law to make their lives easier. In fact, most data suggest that an informal firm's principal desire in formalization efforts is to comply with the law. Yet these firms make an economic decision that leads them to seek profitability outside the formal rule of law. Capitalizing on weak law enforcement and a culture of informality, informal firms face less risk in many developing countries when they avoid the law than they would in a developed country.

Formalization tends to treat all informal firms the same regardless of their reason for operating informally. In order to meet the quantitative goals that many formalization projects include, any informal firm could be registered and checked off as a successful formalization. However, firms transitioning through informality on the road to formal business establishment have very different goals and potential than firms that seek reasonable income to survive. Thus,

116. PERRY, et al.

117. GARY S. FIELDS, *A Guide to Multisector Labor Market Models* (2004).

the results of formalization projects may be skewed as they are more likely to capture firms that would have self-formalized regardless of the intervention.

The fact that the informal economy is heterogeneous should challenge development agencies and policymakers to modify their formalization policies to address the need for economic as well as social and legal incentives. Instead, they group informal firms together and target the firms in the best position to succeed, even though these firms may not need assistance to formalize. They are orienting their projects toward the minority of informal firms at the expense of the substantial number of firms operating with minimal resources and protections.

Formalization and Productivity

Formalization advocates contend that the process of legalization of informal firms will improve their productivity. In a recent World Bank publication, for instance, Yaye Sakho suggests that informal firms in Bolivia can expect to improve their productivity if the state incentivizes them through streamlined regulations and lower taxes.¹¹⁸ Diana Farrell of the McKinsey Global Institute examined the case of Turkey and found that 50 percent of the productivity gap between that country and the United States is accounted for by informality.¹¹⁹ And in the World Bank's flagship report on informality, despite the weak evidence that they attest to, they conclude that: "there are reasons to expect important overall productivity gains

118. YAYE SAKHO, *Increasing Formality and Productivity of Bolivian Firms* (World Bank. 2009).

119. FARRELL, *The Hidden Dangers of the Informal Economy*.

if a larger fraction of firms would formalize and if resources could be shifted away from low productivity informal firms toward the formal sector.”¹²⁰

Most informal firms remain small and unproductive because there is no adequate legal or economic incentive to becoming larger or more productive. For many of these firms, becoming formal would imply costs that would make profit-earning impossible. For these firms, what the state is able to offer in terms of protection and promotion of the firm is far less attractive than what the informal economy offers the firm.

The formalization process is meant to improve the productivity of informal firms by legalizing their operation. By ceding certain freedoms to the state, including the freedom to operate on public space, utilize labor without contributing to social security or pension programs, or sell goods without a license, the state agrees to provide legitimacy to the firm and gives them an opportunity to solicit resources to expand or improve their operation. Once the informal firm becomes legitimate, it is expected to follow the path of a traditional small firm, becoming productive, competitive, and successful.

Yet as La Porta and Shleifer contend, the process of formalization will do little to improve productivity because informal firms are naturally unproductive and legalizing them will not improve their productivity.¹²¹ “Because these firms are so inefficient, taxing them or forcing them to comply with government regulations would likely put most of them out of business, with dire consequences for their employees and proprietors.”¹²² Instead, the authors suggest that developing country policymakers should focus on formal firms and helping them to improve their productivity.

120. PERRY, et al., 157.

121. SHLEIFER, 34-35.

122. Id., 35.

Joseph Schumpeter is one of the best known advocates of dynamic change in the marketplace as a means of driving innovation and economic growth. In his 1942 book, *Capitalism, Socialism and Democracy*, he argues that competition encourages businesses to find new production methods or apply technology in order to avoid being pushed out by more efficient or innovative firms, a process he called “creative destruction”.¹²³ The creative destruction process has driven the development of small firms based upon innovation and technology.

We can relate the creative destruction process to the formalization process. In this sense, formalization may actually be beneficial to the overall economy as it quickly identifies those firms that are unproductive and eliminates them to make room for more productive firms. However, while a state may perceive these more productive firms by necessity to be formal firms, informal firms might also be considered drivers of the creative destruction process, forcing formal firms to innovate or lose market share. In general, the formalization process, which attempts to improve economic productivity, does so by destroying an informal firm to make room for a formal firm. Throughout most of the literature on informality, destruction of these firms is not a reasonable, nor a desirable goal.¹²⁴

Most informal firms remain small and unproductive throughout their short life cycle. In La Porta and Shleifer’s survey, for instance, they found that “[t]here is no evidence that informal firms become formal as they grow. Rather, virtually none of the formal firms had ever been informal.”¹²⁵ These authors contend that formalization will be ineffective because there are few productive gains to be made by formalizing a largely survivalist economy. Tempering this

123. JOSEPH SCHUMPETER, *CAPITALISM, SOCIALISM & DEMOCRACY* (6th ed. 2006).

124. See, e.g., SHLEIFER.

125. Id., 34., see also PERRY, et al.

argument slightly, Victor Tokman suggests that formalization should focus only on those firms that show potential to become productive members of the formal economy.¹²⁶ Small, unproductive, survivalist enterprises are unlikely to improve productivity in the face of state regulation and a licensed operation.

In addition to the weak correlation between formalization and productivity gains, there is no solid evidence to suggest that formalization leads to economic growth. The U.S. Agency for International Development study on formalization reviewed World Bank and other survey data and found that the correlation between size of the informal economy and GDP growth was not statistically significant.¹²⁷ Perry and Maloney reiterate this conclusion in their World Bank report on Informality in Latin America, finding no robust relationship between informality and economic growth.¹²⁸

Productivity gains can certainly be presumed when a state streamlines business registration processes, lowers taxes, and facilitates entrepreneurship; however, this is not accomplished through formalization. Formalization relies on business process incentives to drive the legalization of unproductive firms based upon the mistaken correlation between a better business environment and a demand for formality. It might be argued that improvements in the business registration and operation process lead to the creation of more formal firms. But it cannot be reasonably asserted that informal firms will transform into formal firms on this basis.

126. VICTOR TOKMAN, *Modernizing the Informal Sector*, 42 DESA Working Paper 8(2007).

127. .

128. PERRY, et al., 172.

Chapter 4: Field Methodology

Development of the Research Question

The fieldwork for this thesis was conducted in Colombia between 2006 and 2009. Colombia was selected based upon its status as a middle-income country, its large informal economy, and its efforts to integrate with the global economy through the institution of a trade liberalization program beginning roughly in 1991. Most research was conducted in the capital, Bogotá, with additional data gathered in Cartagena on the Caribbean coast, Medellin, and Popayan.

I received a Fulbright grant to carry-out fieldwork in Colombia in 2006. During this one-year period, I lived in Bogotá and traveled throughout the country observing economic development and commercial activities. Most striking to me at this time was the significant number of street vendors competing for business. They occupied nearly every street corner and most other public spaces throughout the major cities in Colombia. This led me to look more closely at unregulated activity and its impact on the economic development of the country.

In Bogotá, I began speaking with goods vendors, small textile firm operators, and transport operators, to get a sense of the nature of informality and how it affects their business motivations and goals. I learned very quickly that informality was a natural concept, and formality was the exception rather than the rule in many contexts.

I associated with the Universidad de los Andes in Bogotá during my Fulbright grant period. As one of the top research institutions in Latin America, I had access to excellent data and professional resources. I joined the law faculty as a visiting professor of law and began giving classes and presentations on trade and economic development to the University community. This helped me to identify like-minded researchers and students who could ultimately help me to obtain the data that would facilitate my research.

Applied Research Methods

My research focused on both legal and economic aspects of the informal economy and its participants. This required me to isolate two types of data—qualitative data describing the laws and decrees related to small business and trade, experiences of the informal economic workforce, and analyses of the state’s role in informality, as well as quantitative data highlighting trends in informality, linking trade liberalization to informal market activity, and describing the features of informality. Accordingly, I applied a mixed-methods approach to the research.

I began my study by collecting quantitative research about the informal economy. My goal was to develop a complete understanding of its size, growth trends, and participants. With the help of several students and professors in the law and economics departments, I was able to access historical records of census data conducted by the DANE, the Colombian statistics agency. I filtered through hundreds of pages of data from these census records to understand how the government measured informality and unemployment and when they began counting informal workers as part of the labor market. This early data was some of the first to identify

the informal economy in Colombia and to begin measuring its scope. Subsequently, the DANE integrated questions about formality in their household surveys, which they update quarterly today.

In addition to the publicly available data from the DANE, I was able to access their two largest surveys—the Grand Household Survey and their Microenterprise Survey—in their totality. Working with a contact at the Inter-American Development Bank, I was able to review survey questions and the raw data that DANE studies were based upon. This data gave me a much richer sense of who participants in the informal economy are and what their problems and needs are. I used this data to formulate several graphical analyses in this thesis.

Other data was used to supplement my research, including surveys of trade liberalization—foreign investment, exports as a proportion of gross domestic product—conducted by the World Bank and exhibited in their Development Indicators database. Some data not available in that database, including rule of law indicators, was also extracted from their recent flagship report on informality.

With this quantitative data in hand, I developed a plan to engage key actors in Colombia that could provide insights into the Colombian informal economy and the formalization process. These actors included the state, informal firms and workers, and non-governmental organizations working in this area.

With respect to the state, my goal was to develop a better understanding of their view of informality and their efforts to curtail it. Through my contacts at the University where I was teaching, I was able to make contact with senior officials at the DANE, the Ministry of Commerce, the Antitrust Ministry, the Office of the President, Proexport (Colombia's export promotion agency), and the National Planning Agency. I spoke with some of these individuals

via email, but many agreed to extensive interviews. During my interviews, I used a set of guiding questions to gauge each agency's understanding of informality, their explanation of its causes and consequences, and their recommendation for reducing its prevalence. I also requested specific case studies from each agency, which most provided. Finally, in the case of the Ministry of Commerce, which is home to the formalization office, I was able to solicit numerous documents discussing the state's strategies for reducing informality through formalization programs. I discuss this in the case study segment of this thesis.

With respect to non-governmental organizations, my goal was to understand Colombian informality from a third-party perspective and to find out the extent of research that has been done on this subject. The key actor in this area was Fedesarrollo, a think tank focused on economic development in Colombia. I met with the former head of that agency and former Minister of Commerce, Mauricio Cardenas. He introduced me to several other key players in informality, which I included in my research. I also visited Fedesarrollo several times to speak with a senior researcher on informality that recently conducted a survey of two key sectors of informality—small hotels and apparel workers—and shared the resulting data with me. Another key non-governmental actor is the local chamber of commerce, which coordinates firm registration. I spoke with the director of one office at the initial stages of implementing a formalization program. I also spoke with the legal counsel in that office to get a better understanding of how the promotion program worked in a legal sense. I followed-up as the project completed its first stage in order to gather additional data.

Finally, with respect to participants in the informal marketplace, my goal was to learn about their particular circumstances—how did they perceive their current work, their growth opportunities, and their economic sustainability, and how did they feel about formalization.

Although informality tends to occupy a larger share of rural than urban populations, my interest was in small business development, so I limited my selection of interviewees to cities. Also, because Bogotá is the capital and one of the most populous cities in Colombia and because of limited resources, most of my interviews took place in Bogotá. In order to determine the most appropriate individuals to speak with, I sorted my data from the DANE to discern the industries with the largest percentage of informal firms. Outside of natural resource extraction, which I avoided due to issues of safety, service industries and commercial activities were the most prevalent.

In selecting interviewees in the informal marketplace, I focused on the ability to gather complete histories rather than limited statistics (which I could rely on survey data for). I began with the transport sector, which has a significant degree of informality and interacts with a broad segment of the population. I spent substantial time with two taxi drivers, one independent and one part of a cooperative, and learned their stories. I then spoke with street vendors selling fruit, one in Bogotá and one in Cartagena, to understand their unique circumstances and desires. I then spoke with two small business owners, one operating a day care and the other producing textiles. Finally, I spoke with the owner of a small restaurant that recently formalized and the owner of a small construction firm in order to compare their experiences and resources with those of the informals. Additionally, I reviewed audio recordings and transcripts of interviews conducted of trash collectors in Cartagena. These ethnographies greatly illuminated the quantitative data that I previously gathered.

Besides subject-based research, the nature of my chosen topic required me to look extensively into Colombian laws and policies related to informality. Coming from the U.S. system of common law and easily accessible sources of law, my foray into the Colombian legal

system was a significant hurdle. I enlisted the assistance of several Colombian lawyers, including a team of two trade-oriented lawyers that helped me to understand the relevant laws and decrees and the legislative process to put them into effect. My goal was not only to identify the laws that would have the most significant impact on informality and on trade policy, but also to understand why they were developed and how they work in practice. I discuss the results in section III of this thesis.

Research Approach

My research was diverse and profound largely because of the excellent contacts that I developed while at the University and living in Colombia. One of the key actors that I met was the Director of the *Centro interdisciplinario de estudios sobre desarrollo* (Center for interdisciplinary development studies) (CIDER), a center devoted to the study of economic development in Colombia. My interview of the director led me to several key studies that I relied upon in the development of this thesis. I also worked with the Director of the International Law program, Liliana Obregon, who facilitated my ability to access to the Los Andes alumni network in order to begin interviewing top government and industry officials about my research.

One of my students at the University, Juan Pablo Calderon, was working on a thesis focused on trade and economic development. He volunteered to assist me in my research and has been doing so ever since. He has helped me to conduct interviews and schedule meetings, as well as to find useful source material in Colombia when I was not present. As a lawyer and

person interested in economic development in Colombia, his contributions have been invaluable.

I returned to Washington in mid-2007 to begin collating my data and preparing my dissertation proposal. After completing my literature review, I realized the extent of the informal economy and the research already completed on point. In order to parse this research and make a valuable contribution to the field, I had to define a specific set of variables and a theoretical approach. Based upon my experience in the Fulbright program and my background in trade law, I decided to address the impact of law and trade liberalization on the informal economy using Colombia as my case study.

I returned to Colombia many times since 2007 in order to meet with researchers, government officials, and participants in the informal economy. Each time that I returned I considered launching a formal survey to statistically analyze the scope of informality. However, in my experience, in-depth interviews with key actors, an extensive literature review, and on-the-ground experience living and working among the subjects of my research yielded much more productive results.

The implications of this research and the resulting recommendations are directed toward the Colombian policy and legal community. Each country maintains its own legal and policy approach toward addressing informality. Laws are unique to a country and the analysis of those laws cannot easily be transplanted to other countries. However, this limitation should in no way prevent the reader from drawing similarities with their own country, nor in extracting useful tools from the foregoing analysis.

Hypothesis

In this dissertation, I pose the following guiding research question: Will formalization programs, as they are currently conceived, improve domestic economic growth in a weak rule of law environment?

The informal economy is a heterogeneous, largely survivalist business community operating outside the rule of law of the state. It is a legal concept arising from the creation of a state registration system. Trade liberalization policies have spurred the push to formalize firms to promote fair competition, taxation, and the rule of law.

Aside from a small group of entrepreneurial firms, most informal firms will remain informal for the duration of their business life cycle. Attempts to formalize these firms with economic incentives or increased pressure through law enforcement will fail because these incentives fail to address the central rationale for functioning in the informal economy—a failed social contract with the state. Unless and until informal firms develop trust in the state to protect their interests, there is little motivation to operate within the formal rule of law system of the state.

The solution to the problem of rising informality is not to offer economic incentives alone, but rather a combination of transitional mechanisms, legal institution streamlining, and training. States must recognize the dual nature of their economy and build a process that incrementally moves informal firms toward compliance with the law. This process should offer necessary protections, such as social security and health insurance, in exchange for monitoring and minimal regulation, primarily aimed at public health and safety. Legal institution reform can serve as a second mechanism to reduce the scope of informality. By developing streamlined

and accessible small firm resolution centers or processes, informal firms may voluntarily pursue formal dispute resolution more often, improving the culture of rule of law. Finally, no-cost basic training in crucial areas, such as contract negotiation, dispute resolution, and business practice, could benefit the vast majority of informal firms and open new opportunities for them in the formal economy.

PART II: Colombia Case Study

Chapter 5: Case Study – Colombia

The following case study was developed in order to analyze one country's active formalization program in light of the preceding critique. Colombia has a highly developed market and a variety of legal institutions to facilitate market transactions. Since 1991, it has effectively oriented its market toward international trade and economic growth. Yet it also maintains a substantial and growing informal economy. As such, it fits well into the discussion of the relationship between trade liberalization, informality, and rule of law. I gathered much of the data for this case study while living in Colombia as a Fulbright scholar in 2006-07 and during numerous subsequent visits.

The most recent data from the Colombian statistics agency, DANE (similar to the U.S. Census Bureau) show a level of urban informality in Colombia of 58% of the total working population. This corresponds to roughly 5 million people working in the informal economy in Colombia. During the same period in 2007, the rate was 56%, accounting for roughly 5.1 million people. This rate has hovered around 60% for the last ten years.

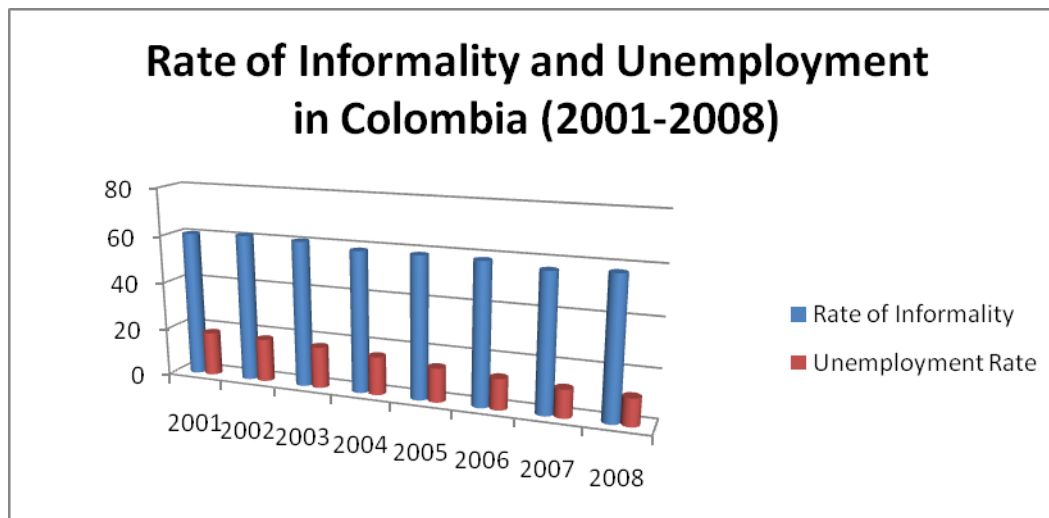


Figure 1. Rate of Informality and Unemployment in Colombia (2001-2008).

In their annual household survey, the DANE defines informality in line with the 1978 International Labor Organization definition. It includes: 1) employees of firms with less than ten workers; 2) unpaid workers in family businesses; 3) unpaid workers in firms; 4) domestic workers; 5) independent workers (except professionals); and 6) employers in firms with less than ten workers. More recent definitions based upon registration with the chamber of commerce, or payment of social security or taxes, were used in other studies by the DANE that will also be referenced in this thesis for comparison.

Firm informality is generally measured by calculating the total number of firms that are small and unregistered with the chamber of commerce. According to the DANE, an informal firm is defined as a small enterprise (less than ten employees) that is generally outside of institutional protection and registration, often run by family members, with low productivity, and unprotected by social security laws.¹²⁹ A more recent document evaluating Colombian

129. See, e.g., DEPARTAMENTO ADMINISTRATIVO NACIONAL DE ESTADÍSTICAS, *Informalidad y Pequeña Industria, una Aproximación a su Medición en las Cuentas Nacionales de Colombia, año base 2000*, 7 (2006).

methods of informal economy measurement suggested that informal firms usually fall into one of the following categories: 1) lack of registration with the chamber of commerce; 2) no accountability to any person or entity; 3) non-payment of taxes the previous year; or 4) non-payment of social security for employees the previous year.¹³⁰ Each of these categories yields a different result in the measurement of informality in Colombia, as noted in Table 1, below.

Table 1. Incidence of Informality in Small Business in Colombia measured by registration with the *registro mercantil*, accountability (owner-operator), tax payments, and social security payments, 2002-2003.¹³¹

Source: Mejia (2007).

	2000	2001	2002	2003
<i>Merchant Registration</i>				
Formal			65.8%	54.1%
Informal			34.2%	45.9%
No. Observations			11,714	17,103
<i>Accountability</i>				
Formal			57.6%	57.8%
Informal			42.4%	42.2%
No. Observations			11,879	17,464
<i>Tax Payments</i>				
Formal	58.1%	61.5%	56.9%	46.5%
Informal	41.9%	38.5%	41.1%	53.5%
No. Observations	18,331	13,601	11,879	17,464
<i>Social Security Payments</i>				
Formal	37.4%	32.4%	35.8%	32.6%
Informal	62.6%	67.6%	64.2%	67.4%
No. Observations	18,331	13,561	11,878	17,464

Within the small enterprise sector, the vast majority of small firms in Colombia are informal. According to the most recent data from the DANE 1-2-3 survey (2003), approximately 46 percent of all small firms in Colombia are informal. This is a significant finding as small

130. MAURICIO CARDENAS AND CAROLINA MEJIA, *Informalidad en Colombia: Nueva Evidencia*, 35 Inter-American Development Bank Working Paper, 21-22 (2007).

131. Id., 22.

business has been characterized as an important driver of economic growth for the country. A complete understanding of this sector is necessary not only to understand informality, but also to understand the behavior of such an important engine of growth.

The majority of unregistered firms in Colombia have been in business for less than three years—most of those for less than one year. Yet about 21% of unregistered firms have been in business for more than ten years.

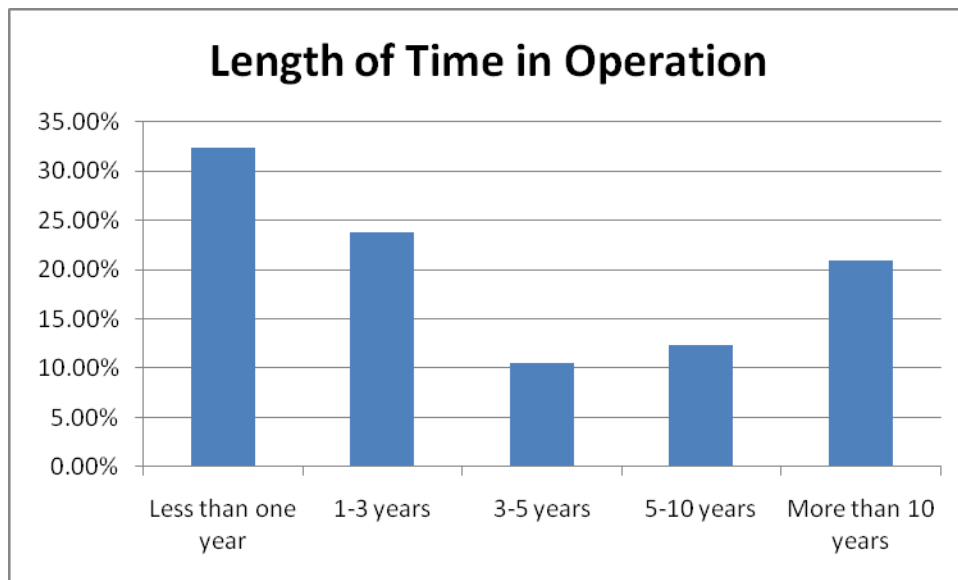


Figure 2. Colombian Unregistered Firms - Length of Time in Operation.

The DANE survey inquired as to the reason the roughly 3,000 firms that identified themselves as unregistered chose to begin their own operation. The majority either wanted to be independent or could not find other work. A significant portion also said that they needed additional income, possibly suggesting that their business is a second income to a primary job elsewhere in the economy.

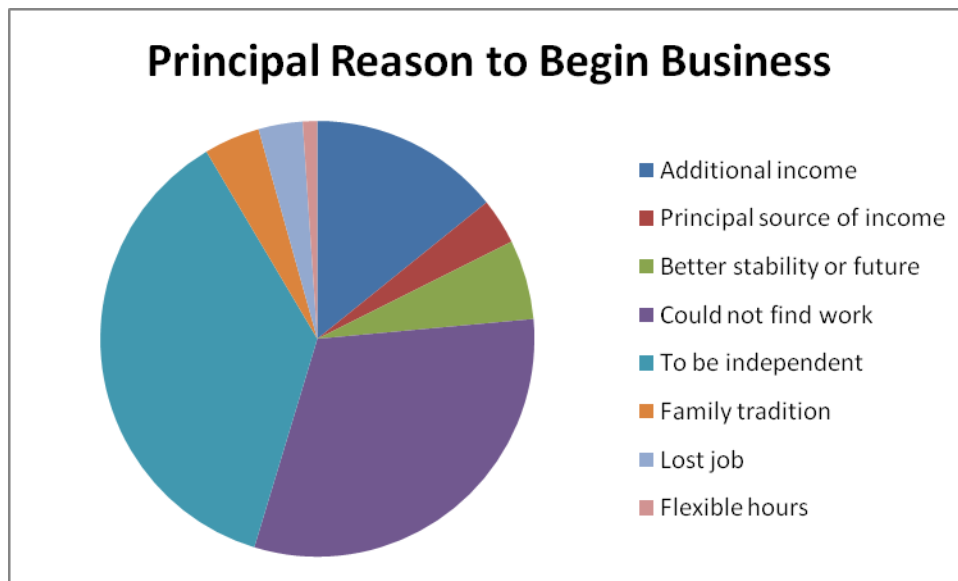


Figure 3. Principal Reason to Start Business.

Of the surveyed firms, the most common reason for not registering with the chamber of commerce was a belief that it was in fact unnecessary to do so. As Law 232 (1995) in Colombia clearly requires *all* businesses to register with one of the 57 local chambers of commerce before beginning operation, the large percentage of unregistered firms that believe they do not have to register may be part of a cooperative or a larger enterprise that has already registered on their behalf. Of the remaining firms, most contend that either they do not know how to register, it is too expensive to register, or it is too complicated to register.

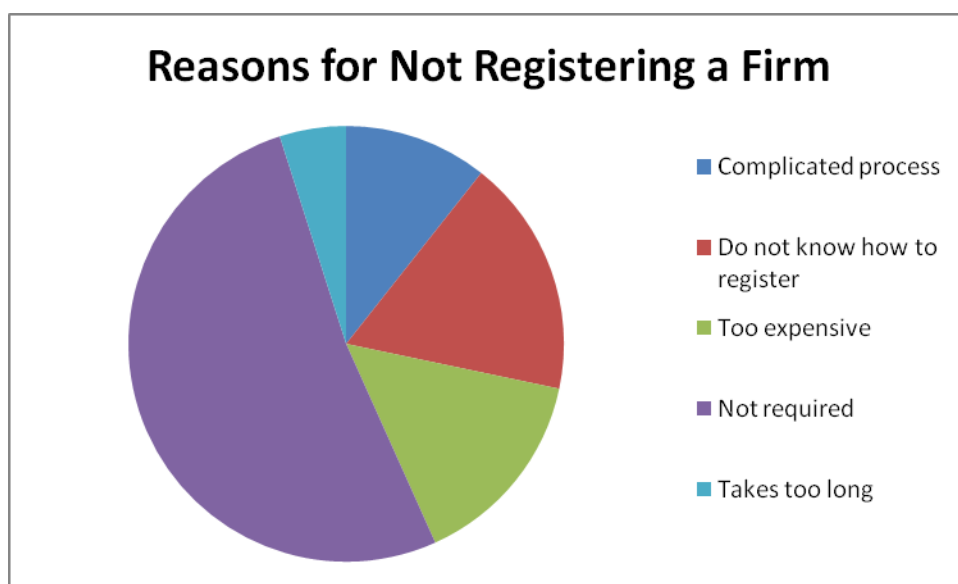


Figure 4. Basis for Not Registering with the Chamber of Commerce.

The business registration process in Colombia was recently streamlined and is considered one of the easiest and fastest such processes in Latin America. A US\$3.1 million Inter-American Development Bank project launched in 2001 to streamline administrative processes in the private sector helped Colombia to reduce its registration process for new entrepreneurs from 18 procedures across eight government offices averaging 53 days to one procedure at one office over two days.¹³² The project was completed in 2004 and has led to the creation of small business service centers (centros de atención empresarial) in the major cities of Bogotá, Barranquilla, Bucaramanga, Cali, Cartagena and Medellín.¹³³ It is now under consideration for implementation in the remaining 51 cities that have a chamber of commerce.

132. INTER-AMERICAN DEVELOPMENT BANK, *Lessons Learned: Business Registration Made Simple Project Documents Stories of Change* at

<http://www.iadb.org/mif/lessons/lessonlearned.cfm?lesson=3&tab=1&Language=English&parid=4>.

133. Project: Streamline Administrative Process Private Sector. (2001).

The DANE Microestablishment Survey, conducted in 2004, is a very comprehensive look at firm activity in Colombia. Of the more than 54,000 firms surveyed, the majority were found to be unregistered (41%). Similar results to those of the DANE 1-2-3 survey were found in this research. Again, the vast majority of firms have only been in operation for less than three years, with a subset of 13% in operation for more than ten years. Yet this survey goes further and breaks down the type of work that the firms are engaged in. Most informal work, according to this survey, takes place in the sales sector. The next two categories – other services and modified goods sales – suggest that goods and services sales, as opposed to production, constitute the bulk of informal business in Colombia.

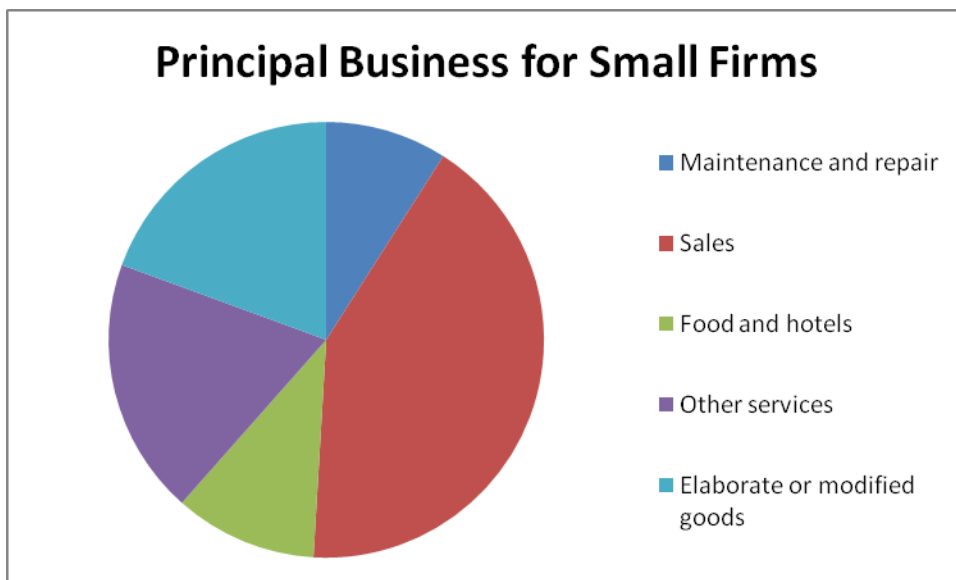


Figure 5. Principal Area of Business for Small Firms in Colombia.

Also in this report, the DANE compared the context of various economic sectors based upon the level of participation of formal and informal firms. The table below represents the broad distribution of informality across sectors of employment in Colombia. The most

significant incidence of informal work in Colombia involves the sale of goods, provision of services, or operation of a hotel or restaurant.

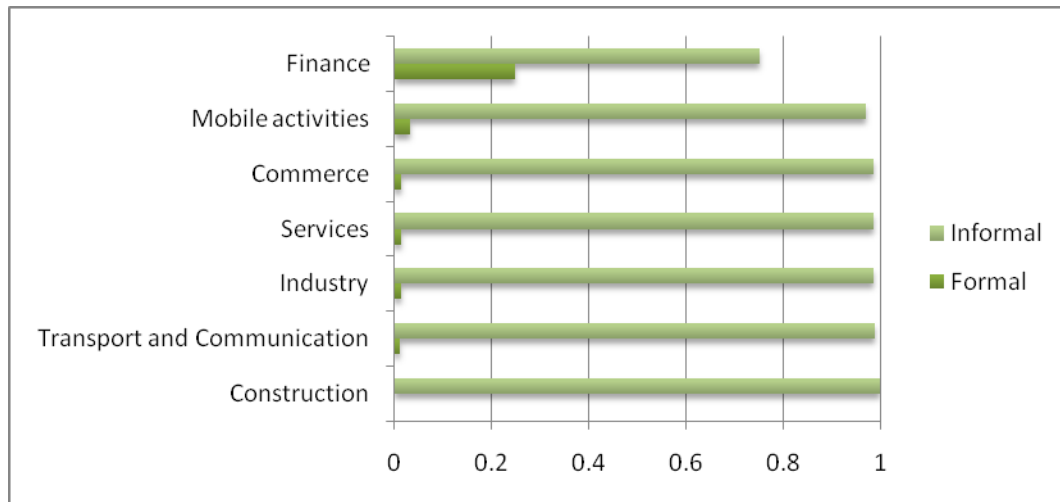


Figure 6. Distribution of small formal and informal firms in Colombia by industry.¹³⁴
Source: DANE (2003).

The range of activities that comprise the Colombian informal economy is impressive. A walk down a main avenue in Bogotá brings an observer face to face with street vendors of every sort, both mobile and fixed; small, unregistered shops occupying alcoves and other small spaces; entertainers performing for passerbys; and a host of services for passing cars, such as window washing and parking guides. Yet these are only the visible components of the informal economy. Hidden behind doors and uniforms are a host of other unregistered operators, including textile workers, daycare providers, house cleaners, day laborers, and contract workers. Each of these individuals plays a crucial role in the Colombian economy.

134. DEPARTAMENTO ADMINISTRATIVO NACIONAL DE ESTADÍSTICAS, *1-2-3 Household Survey*, (2003). See also ESTADÍSTICAS, *DANE*, 12.

The impact of informality on the Colombian economy is substantial; however, it is difficult to fully grasp the relationship between informality and economic growth potential. Colombia recognizes the impact of a large informal economy on its economic development and has taken steps to expand its blanket of registration for firms, enacted strong worker protections, and improved enforcement mechanisms. Seeing firm informality as a cloak for microenterprise, Colombia has actively pursued registration programs using the microenterprise promotion model.

The Colombian state is an active participant in the effort to reduce informality and encourage small business development. Yet their approach, while well-intentioned, is likely inadequate to reduce growth in the informal sector. This chapter reviews the background on the Colombian informal economy, the significant approaches taken to reduce the negative impact of informality, and the challenges that the country faces in achieving their intended outcomes.

Background on the Colombian Informal Economy

Colombia maintains one of the largest informal economies in the developing world, with roughly 60 percent of its working population working outside the bounds of the law and between 35 percent and 60 percent, depending on the definition, operating informal firms.¹³⁵ Over half of the population works without job security, without reasonable living wages, with little or no public service benefits such as social security or medical coverage, and is likely on the

135. DEPARTAMENTO ADMINISTRATIVO NACIONAL DE ESTADÍSTICAS, *Gran Encuesta Integrada de Hogares: Distribución Porecentual de la Población Ocupada Total, Informal y Formal Segun Sexo*, (2007).

road to worsening poverty. And nearly every small firm lacks access to protection from the state, including reasonable access to the courts, property right protection, and state finance. According to some authors, this fact represents one of the greatest challenges to the development of the country.¹³⁶

According to Francisco Thoumi, the former chief of the International Economics and Infrastructure section of the Inter-American Development Bank, the rise in the informal economy, which he posits began in the 1970s, is one of the main reasons for a weakening rule of law in Colombia.¹³⁷ Thoumi finds that the expanding informal economy has “made respect for the law more costly and...has made engaging in illegal activity more acceptable.”¹³⁸

While some authors have drawn linkages between informal work and the formal global economy,¹³⁹ the majority of informal workers are excluded from global opportunities and are “confined to restricted markets.”¹⁴⁰ Thoumi argues that the growth of the informal economy has made it more difficult for Colombia to compete internationally in markets where economic growth has the potential to increase income and well-being. His conclusion is largely founded on the substantial drug trade, where many Colombian youths work in place of gaining an education or seeking more skills-intensive industry training.¹⁴¹

136. See, e.g., FRANCISCO E. THOUMI, *Some Implications of the Growth of the Underground Economy in Colombia*, 29 *Journal of Interamerican Studies and World Affairs*, 35-37 (1987).

137. *Id.* at 38.

138. *Id.* at 44.

139. See generally, MARJIT & MAITI.; see also TREBILCOCK. (finding small linkages, if any).

140. TREBILCOCK. at 5.

141. THOUMI. at 48.

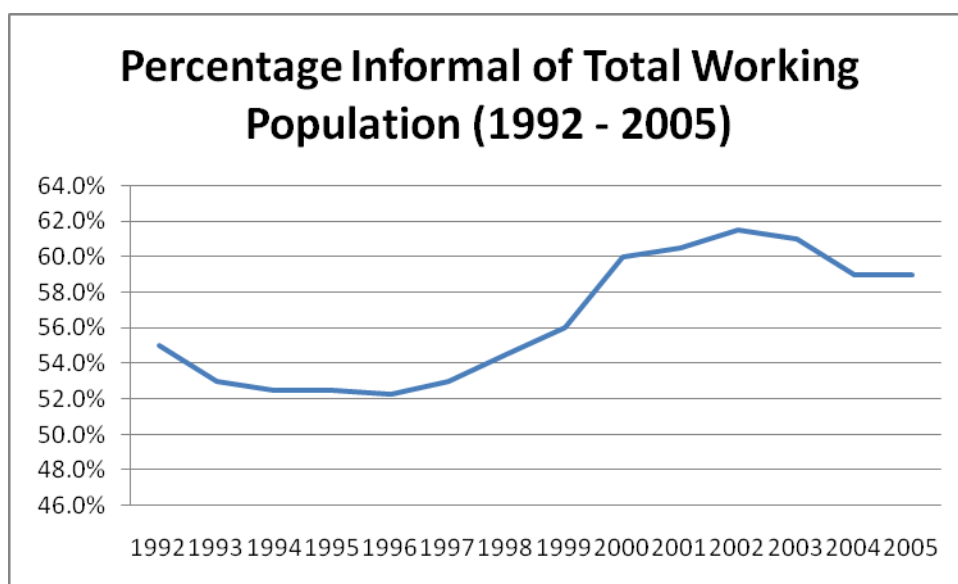


Figure 7. Informality as a percentage of total employed population, 1992-2005.¹⁴²

Source: Ministerio de Comercio de Colombia (2006).

The growth of the informal sector in Colombia may be partially linked to the rapid growth of the nation's urban areas, a result of mass migration and displacement of workers in rural areas by the guerillas.¹⁴³ Conditions which contribute to increased migration "ha[ve] a large impact on the probability of being employed in the informal sector."¹⁴⁴ A significant contingent of informal workers in Colombian cities has been displaced by guerilla activity in their home towns. Additionally, the informal economy grew due to a decline in the demand for labor during the economic downturn of the 1990s.¹⁴⁵

Despite the limited number of firms that can take advantage of international trade in many developing countries, efforts at trade liberalization continue. These international trade reforms can have a substantial, negative impact on the labor market in a developing country.

142. INDUSTRIA Y TURISMO MINISTERIO DE COMERCIO, REPÚBLICA DE COLOMBIA, La política de desarrollo empresarial y la formalización del empleo (Sergio Diazgranados ed., 2006).

143. CARMEN ELISA FLÓREZ, Migration and the Urban Informal Sector in Colombia 3 (2003).

144. Id. at 2.

145. Id. at 6.

Dani Rodrik finds that global trade favors capital-intensive as opposed to labor-intensive industries, placing most developing countries with their labor-intensive economies at a significant disadvantage.¹⁴⁶ Additionally, trade liberalization often has the effect of increasing competition in the domestic marketplace. As demand for labor decreases, informal workers proliferate and the number of workers with unstable and generally lower-paying positions increases:

[G]lobal competition tends to encourage formal firms to shift formal wage workers to informal employment arrangements without minimum wages, assured work, or benefits and to encourage informal units to shift workers from semi-permanent contracts without minimum wages or benefits to piece-rate or casual work arrangements without either assured work, minimum wages, or benefits.¹⁴⁷

The informal sector in Colombia is expanding rather than contracting.¹⁴⁸ Less work available due to increases in technology and increasing foreign competition, combined with a growing labor force, has reduced the size of the formal economy and lead many workers to seek alternative employment opportunities. For many, this results in the establishment of sole proprietorships, which may be nothing more than street vending or entertaining. In Colombia, this is evident in gratuity-oriented positions, such as parking lot attendants guiding your car into and out of spaces for a few coins, entertainers and window-washers at every stoplight looking for *monedas*, and supermarket grocery baggers that will pack your food and walk it to your car (or all the way to your house if you like), all earning nothing more than the money you are

146. See MARTHA ALTER CHEN, et al., *Mainstreaming Informal Employment and Gender in Poverty Reduction: A Handbook for Policy-makers and other Stakeholders 2* (Commonwealth Secretariat. 2004). See also DANI RODRIK, *Has Globalization Gone Too Far?* (1997).

147. MARILYN CARR & MARTHA ALTER CHEN, *Globalization and the Informal Economy: How Global Trade and Investment Impact on the Working Poor*, WIEGO (2001).

148. See, e.g., , *La informalidad laboral se mantiene en el 64% (The Informal Labor Market Stays at 64%)*, El Tiempo Portafolio 2007.

willing to give. These informal workers provide a service that some people find useful and for which they are willing to pay for. What is increasingly apparent, however, is that these informal positions are themselves in high demand. Using the supermarket grocery bagger example once again, you will rarely find less than two workers bagging your groceries at the same time, and in some cases as many as four or five. Demand for the change in your pocket is growing.

This problem is not unique to Colombia, but Colombia stands out as an example of a failure to reduce the reliance on informal work despite overall economic growth. Colombia is a middle-income country, an active member of the GATT and WTO, and the fifth-largest recipient of U.S. foreign assistance monies.¹⁴⁹ All of this indicates that Colombia should be able to invest in its population in order to prevent more workers from falling into the poverty trap of working in unsustainable positions. Yet as the informal sector grows, it becomes apparent that increased aggregate economic growth is failing to alleviate a substantial economic development problem.

149. See Foreign Aid: An Introductory Overview of U.S. Programs and Policy. (2004). (indicating that Colombia received US\$570 million in FY2004), at <http://fpc.state.gov/documents/organization/31987.pdf>.

Chapter 6: International Trade Law in Colombia

As discussed above, a country's choice of trade policy can have a significant impact on its long-term development and on the size and growth of its informal economy. Whether a country chooses to use its informal economy to position itself as a destination for lower labor costs and cheap intermediate goods, or whether it implements domestic policies to curb growth in the informal economy in order to attract long-term investors, may drive the economic development of that country.

Colombia has not always been open to trade. Like many other Latin American countries during the 1960s and 1970s, Colombia relied on a policy of import substitution whereby it followed the logic of economists of the day who suggested positive economic growth would result if the country reduced imports and facilitated domestic production of those previously imported items. Colombia carried out this policy via Decree 1345 of 1959 and Law 81 of 1960, which offered tax-free treatment to domestic producers.¹⁵⁰ This policy contradicted David Ricardo's theory of comparative advantage, which suggested that countries should focus on

150. REPUBLIC OF COLOMBIA, Decree 1345 (Diario Oficial de Colombia ed., 1959).; REPUBLIC OF COLOMBIA, Law 81 (Diario Oficial de Colombia ed., 1960).

producing what they can produce most efficiently, allowing other items to be imported from countries that can produce them more efficiently.¹⁵¹

In 1966, under the presidency of Carlos Lleras Restrepo, Colombia conducted national budget planning, implemented administrative innovation, and began to emphasize exports.¹⁵²

Between 1970 and 1974, under Misael Pastrana Borrero, Colombia enjoyed the period of its greatest economic growth in the last half century, averaging 5.8% annually.¹⁵³ During this period, Pastrana focused on enhancing the internal urban industrial sector, which grew from 21.3% to 23%.¹⁵⁴ However, inflation also grew from 7.2% in 1970 to 25.2% in 1974, along with a rise in urban unemployment from 9.7% to 11.6% by 1974.¹⁵⁵ Lopez Michelsen took the presidency in 1974 and focused his national development plan on decentralization, emphasizing city collaboration and restricting foreign direct investment.¹⁵⁶ This process was continued by Turbay Ayala between 1978 and 1982.¹⁵⁷ Law 38 of 1979 forged a permanent linkage between regional and national development plans, offering significantly more influence of regional bodies on national development goals.¹⁵⁸

Developing new industries to produce products that could be imported cheaply became exceedingly difficult and costly and dragged Colombia into debt. Accordingly, Colombia followed many of its neighbors and began to open its borders to free trade. At the time, the

151. DAVID RICARDO, *The Principals of Political Economy and Taxation* (E. C. K. Gotter ed., George Bell and Sons. 1817). at 113-17.

152. EDGAR MONCAYO JIMINEZ, *Nuevos Enfoques de política regional en América Latina: El caso de Colombia en perspectiva histórica* [New Approaches to Regional Politics in Latin America: the Case of Colombia in Historical Perspective], 198 *Archivos de Economía* (2002).

153. *Id.* at 9, 12–13.

154. *Id.* at 13.

155. *Id.*

156. *Id.* at 13–15.

157. *Id.* at 17.

158. *Id.* at 19–20.

favored policy in Latin America for trade was based on the Washington Consensus, a policy initiative put forth by the United States that encouraged rapid reduction of all barriers to international trade and legal reform to conform with developed country standards.¹⁵⁹ Colombia chose to embrace this initiative and began the substantial reduction of its barriers to trade. Infant industries were abandoned in place of more competitive imports, and subsidies and state-owned industries were all but eliminated.

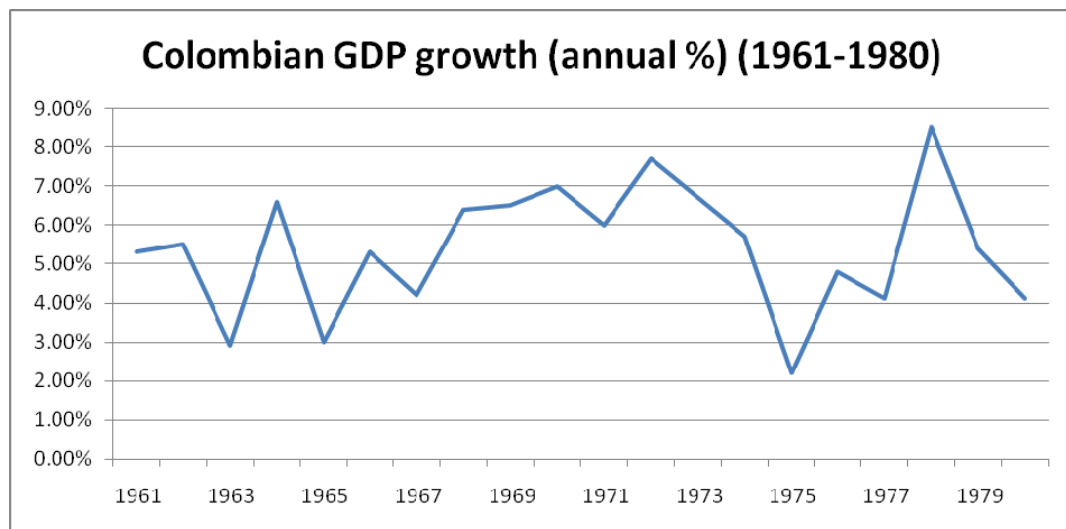


Figure 8. Colombian GDP Growth (1961-1980).
 Source – World Bank Development Indicators.

As the chart above reflects, Colombian GDP growth accelerated around 1965 and maintained a period of growth through 1972. This was a period in which Colombia was reducing its import substitution policies and shifting toward a more open model of trade. During the Pastrana presidency of 1970-1974, import liberalization increased as did investments in urban infrastructure. Global economic growth during this period benefitted Colombian exports, but

159. JOHN WILLIAMSON, *The Washington Consensus as Policy Prescription for Development* (2004).

inflation grew significantly causing overall GDP growth to drop.¹⁶⁰ In 1975, an international coffee boom led Colombia to shift many of its resources away from more productive exports and into the coffee sector.¹⁶¹ Real income in Colombia increased until the early 1980s, when marijuana and cocaine exports came to dominate foreign trade.

In 1981, Colombia approved Law 45, which instituted the Treaty of Montevideo, creating the Latin American Integration Association.¹⁶² This association replaced the Latin American Free Trade Association, established in 1980 with the intention of facilitating a common market in Latin America. The agreement set forth a regional tariff preference scheme in 1984, offering a range of reductions in import tariffs depending on the developmental status of member states.¹⁶³

Economic Openness in Colombia

In the 1990s, Colombia began to open its economy to external trade via a series of changes in the law and policy of foreign commerce. In Latin America during this period, the ten recommendations of the Washington Consensus were promoted and, to a large extent,

160. CARLOS F. DIAZ-ALEJANDRO, *Trends and Phases in the Colombian Economy and Its Foreign Trade and Payments, 1950-72* (1976).

161. JORGE GARCIA GARCIA & GABRIEL MONTES LLAMAS, *Coffee Boom, Government Expenditure, and Agriculture Prices: The Colombian Experience*, International Food Policy Research Institute (1988).

162. In Spanish, this association is called the Asociación Latinoamericana de Integración (ALADI). See *International Training Centre of the International Labour Organization, Latin American Integration Association*, at <http://www.itcilo.org/actrav/actrav-english/telearn/global/ilo/blokit/aladi.htm>.

163. Id.

implemented.¹⁶⁴ The following is a general overview of the major changes that took place between 1991 and 2003 resulting in liberalized trade in Colombia

La Apertura (the opening of the Colombian economy to international trade), began around 1990, after dissatisfaction with the economic growth of the 1980s.¹⁶⁵ In 1990, Colombia started an intense process of structural adjustment, which included most of the recommendations of the Washington Consensus. Economic and institutional modernization, internationalization of the economy, flexibilization of the labor market and incorporation of private enterprises for the provision of social security services were the main objectives of this political agenda.¹⁶⁶ These reforms included fiscal decentralization, which resulted in increased government spending, thereby steadily increasing the central deficit during the 1990s.¹⁶⁷

Colombia instituted a new constitution in 1991, and with it, many changes to the administrative organization of the political structure.¹⁶⁸ Of specific interest to this study, Article 225 established the Advisory Commission of Foreign Relations to advise the president;¹⁶⁹ Article 226 instructed the state to promote internationalization of political, economic, social, and ecological matters on the basis of fairness, reciprocity, and national convenience;¹⁷⁰ Article 227 instructed the state to promote economic, social, and political integration with other countries in Latin America and the Caribbean on the basis of fairness, reciprocity, and equality, including

164. ANTONI ESTEVADEORDAL & ALAN M. TAYLOR, *Is the Washington Consensus Dead? Growth, Openness, and the Great Liberalization, 1970s–2000s* 14264 Nat’l Bureau of Econ. Research, Working Paper (2008).

165. MEJIA, at 3–4.

166. JAIRO GUILLERMO ISAZA CASTRO, *Women Workers in Bogota’s Informal Sector: Gendered Impact of Structural Adjustment Policies in the 1990s* (Departamento Nacional de Planeación 2003).

167. MEJIA, at 5, 24–26.

168. See, e.g., CASTRO, at 24 (discussing liberalization of foreign transactions, redefinition of state functions, and labor and social security reform).

169. REPUBLIC OF COLOMBIA, *Constitución Política de la República de Colombia* (1991), at art. 225.

170. Id. at art. 226.

the establishment of a supranational governing structure;¹⁷¹ and Article 334 placed the state in charge of the direction of economic development through the control of production, distribution, and consumption of goods and services to improve the quality of life and attain equitable distribution of the opportunities and benefits of development.¹⁷²

Also in 1991, Colombia approved Law 7, which set the foundation for international trade. This law established the general rules that the Colombian government would have to follow in its foreign commerce.¹⁷³ It created the Ministry of Foreign Trade¹⁷⁴ and established the functions and structure of the Foreign Trade Council.¹⁷⁵ The law also created the Bank of Foreign Trade¹⁷⁶ and the Economic Modernization Fund.¹⁷⁷ In effect, this law established structure and guidelines for the government to follow in all future attempts to regulate foreign commerce, including (1) the enhancement of international integration with the goal of growth and sustainable development,¹⁷⁸ (2) promotion of exports,¹⁷⁹ (3) stimulation of bilateral and multilateral trade agreements,¹⁸⁰ (4) modernization and increased efficiency of domestic production to improve international competitiveness,¹⁸¹ and (5) protection for domestic industry when facing unfair foreign competition.¹⁸²

171. Id. at art. 227.

172. Id. art. 334.

173. REPUBLIC OF COLOMBIA, Ley 7 (Diario Oficial de Colombia ed., 1991).

174. Id. at arts. 17–20.

175. Id. at art. 12.

176. Id. at art. 21.

177. Id. at art. 22.

178. Id. at art. 2.1.

179. Id. at art. 2.2.

180. Id. at art. 2.3.

181. Id. art. 2.4.

182. Id. at art. 2.5; see also COLOMBIA, Ley 7. at art. 10 (allowing protective mechanisms for domestic industry to be implemented when unfair foreign competition threatens domestic economic growth).

The Foreign Trade Council was established in 1991 to, among other things, set tariff levels, advise the government on trade policy, instruct the delegations that represent Colombia in foreign trade negotiations, determine the best approach to export promotion, and advise the government on the protection of domestic industry against unfair foreign practices.¹⁸³

In accordance with Law 7, Colombia took two major steps toward international integration in 1994 when it joined the Marrakesh Agreement establishing the WTO,¹⁸⁴ and when it established a free trade agreement with Mexico and Venezuela.¹⁸⁵ The latter treaty's goals included reducing trade barriers between the parties, diversifying their exports, and promoting fair competition.

Colombia also entered into a trade framework agreement with the European Economic Community (EEC).¹⁸⁶ This agreement was established between the EEC and the Andean Community, comprised of Colombia, Bolivia, Ecuador, Venezuela, and Peru.¹⁸⁷ The agreement set out to foster commerce, investment, and technological advances. It gave special regard to the Andean Community as a group of developing states,¹⁸⁸ and sought to stimulate diversification of exports, the opening of new markets, the protection of foreign investments, and the exchange of statistical information.¹⁸⁹ The agreement focused in particular on the following sectors: industrial, agrarian and mining, agriculture and fishing, energy, environmental protection, technology transfer, intellectual property, quality certification, services, monetary information, sanitary and phytosanitary regulations, and regional economic

183. COLOMBIA, Ley 7. at art. 14.

184. REPUBLIC OF COLOMBIA, Ley 170 (Diario Oficial de Colombia ed., 1994).

185. REPUBLIC OF COLOMBIA, Ley 172 (Diario Oficial de Colombia ed., 1994).

186. The agreement was signed between the EEC member states and the signatories to the Cartagena Agreement, which formed the Andean Community, in April 1993.

187. REPUBLIC OF COLOMBIA, Ley 183 (Diario Oficial de Colombia ed., 1995).

188. Id. at art. 2.

189. Id. at art. 3(1).

development.¹⁹⁰ The agreement aimed to promote trade fairs and conferences the exchange of experts, and the creation of joint ventures.¹⁹¹

The Ministry of Commerce, Industry, and Tourism was created by Law 790 in 2002 and implemented by Decree 210 in February 2003.¹⁹² This Ministry combined the functions of the former Ministry of Economic Development and the Ministry of Foreign Trade.¹⁹³

In 2004, Colombian president Alvaro Uribe instituted his National Development Plan.¹⁹⁴ The plan was formulated around the idea of sustainable economic growth, macroeconomic price stability, sustainable debt, and access to Colombian markets. Taking into account the concerns of the international community surrounding the drug trade and related crimes, terrorism, corruption, and environmental and human rights concerns, the plan's primary focal point was export promotion. The plan also alluded to the consolidation of the Andean Community with its Latin American neighbors as well as the facilitation of the Andean Trade Promotion and Drug Eradication Act ("ATPDEA") with the United States.¹⁹⁵ Additionally, the plan sought to conclude the Free Trade Area of the Americas, a goal that was not achieved by the Uribe Administration.¹⁹⁶

190. Id. at art. 3(2).

191. Id. at art. 3(3).

192. REPUBLIC OF COLOMBIA, Ley 790 (Diario Oficial de Colombia ed., 2002).

193. Id. at art. 4.

194. REPUBLIC OF COLOMBIA, Ley 812 (Diario Oficial de Colombia ed., 2003).

195. Note that the ATPDEA ended in 2006 and was replaced by the U.S.-Colombia Free Trade Agreement (2006). THE OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE, *Press Release: United States and Colombia Sign Trade Promotion Agreement*, (2006).

196. See, e.g., , *Bush Tries to Reassert US Influence in Region*, Latin American Weekly Report March 15, 2007. 2007. (discussing the change to the promotion of bilateral agreements in the face of an unlikely FTAA conclusion).

Two Decrees in 2005 and 2006 were issued to modify the functions of the Ministry of Commerce, Industry, and Tourism.¹⁹⁷ The Ministry's role is to adopt and coordinate the economic and social policies of the country pertaining to competitiveness, integration, and development of the productive economic sectors comprised of small and medium businesses, foreign trade of goods and technology transfer, promotion of foreign investment, and internal commerce and tourism.¹⁹⁸ Thus, these extensive decrees gave the Ministry responsibility for promoting exports, facilitating foreign investment, negotiating trade agreements, promoting small and medium enterprises, and establishing import tariffs.

It would be incorrect to presume that the expansive laws in Colombia relating to trade are rigorously adhered to in every instance. Generally speaking, the rule of law in Colombia is very weak due to weak enforcement and a lack of meaningful constraints on the elite.¹⁹⁹ Yet this is not unique to Colombia. "After more than ten years and hundreds of millions of dollars in aid, many judicial systems in Latin America still function poorly."²⁰⁰ Lack of funding for effective police forces—and in Colombia's case, significant emphasis on military actions against the guerillas rather than on civil law enforcement—yields an environment in which laws are often ineffective. Accordingly, many of the aforementioned laws appear *prima facie* to be effective developmental solutions, yet they have yet to be successfully implemented.

197. REPUBLIC OF COLOMBIA, Decree 4269 (Diario Oficial de Colombia ed., 2005).

198. REPUBLIC OF COLOMBIA, Decreto 2785 (Diario Oficial de Colombia ed., 2006).

199. See, e.g., DAVID FERRANTI, et al., *Inequality in Latin America: Breaking with History?*, World Bank (2004). (finding that Latin American countries in general maintain weak institutions and few constraints on the power of the elite class).

200. THOMAS CAROTHERS, *Promoting the Rule of Law Abroad: In Search of Knowledge* (Carnegie Endowment for International Peace 2006). at 11.

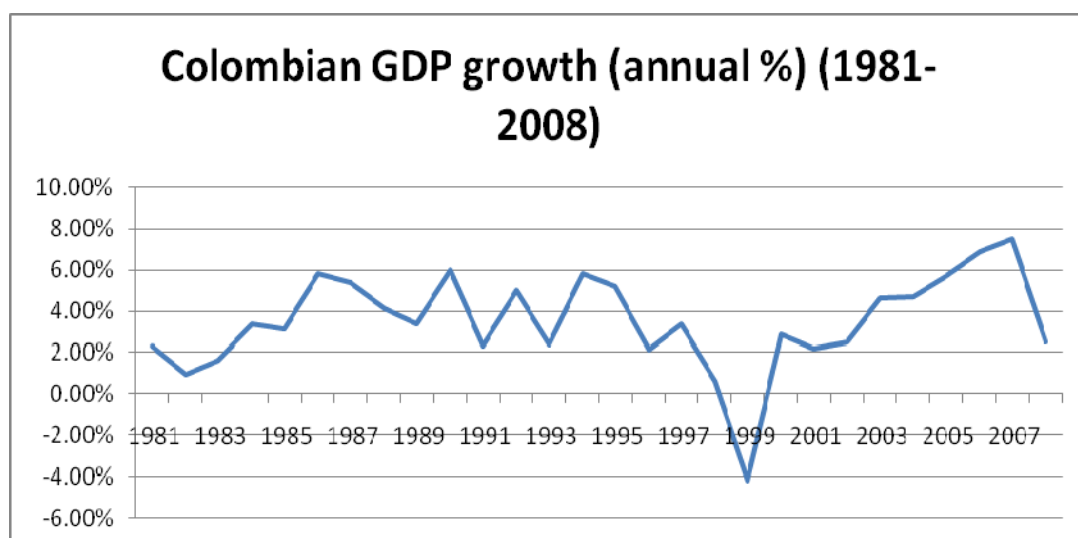


Figure 9. Colombian GDP Growth (1981-2008).
Source: World Bank Development Indicators

Average GDP growth in Colombia fell from an average of 5.4% in the 1961-1980 period to an average of 3.5% in the 1981-2008 period. The global economic crises of 1997, after the crash of the Asian Tiger Economies, and the more recent housing bubble crash of 2007, temporarily interrupted an otherwise stable growth trend. Colombia expects its GDP growth in 2009 to be 0.5% and predicts a rate of 2.5% in 2010.

An increase in the number of exports can be an indicator of integration into the global economy. Export promotion in Colombia began during its import substitution days with the 1967 establishment of Proexpo (now known as Proexport) and decree 444, which introduced incentives to promote exports. Only after the 1991 reforms and the enactment of Law 7 (1991), which established a Ministry of Trade and turned Colombian trade policy outward, did export promotion become a major endeavor. Today, exports are a substantial portion of the Colombian economy. Since 2001, exports from Colombia have significantly increased from

roughly US\$1.7 billion to US\$3.4 billion in 2009. The vast majority (44.6%) of these exports are destined for the United States, the European Union (15.5%) and China (6.0%).

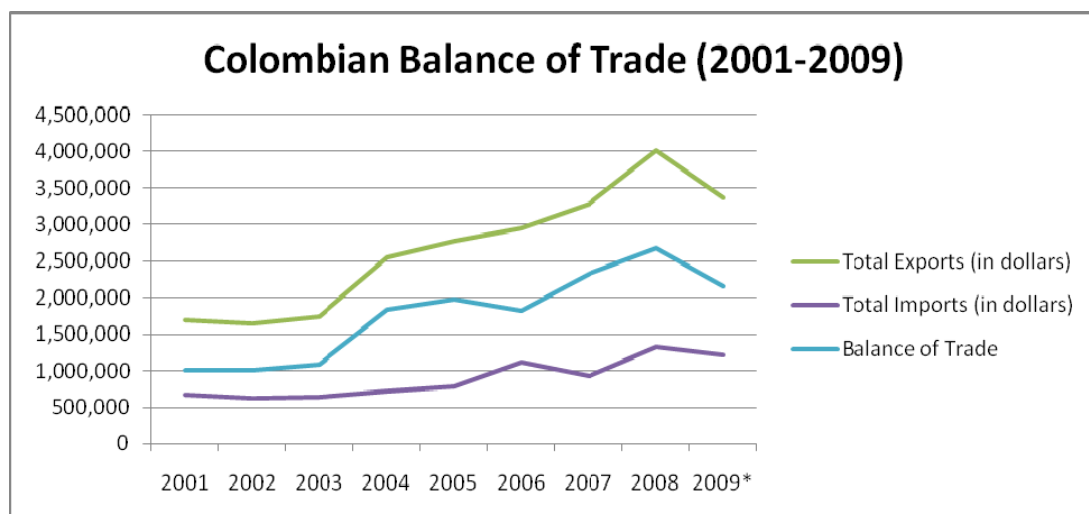


Figure 10. Balance of Trade in Colombia (2001-2009).

Traditional Colombian exports include petroleum, coal, coffee, and nickel. These exports account for approximately 65% of total exports (2010). The most recent data on exports shows an increase of approximately 34% for these exports. Non-traditional exports, which include sugar (10%), chemicals (11%), gold (14%), tobacco (16%), and plastics (9%), account for the remaining 35% of total exports. This proportion of the economy declined by 8.7% in 2010, largely due to a drop in exports of live animals, basic metals, paper, and confections.²⁰¹

Doing Business in Colombia

201. DEPARTAMENTO ADMINISTRATIVO NACIONAL DE ESTADISTICA, Boletín de Prensa - Comercio Exterior - Exportaciones (2010).

Colombian reform efforts have not been in vain. In addition to rising GDP and increasing exports, Colombia has secured a more favorable position on the World Bank's Doing Business report, a key indicator for many foreign investors. The report measures every major economy on a number of factors important to investors, including the length of time and cost for starting or closing a business, tax rates, property registration processes, contract enforcement, and access to credit. As a country streamlines its procedures, it improves its position on the list, giving confidence to potential investors.

Colombia was ranked as number 53 out of 181 in the 2009 Doing Business Report, as compared to 66 in 2008.²⁰² Colombia steadily improved its position with respect to the ease of starting a business, paying taxes, and exporting. It has made little or no progress, however, in the ease of dealing with construction permits, employing workers, registering property, accessing credit, protecting investors, enforcing contracts, and closing a business.

Colombian Trade Liberalization and Informal Economic Expansion

The expansion of trade liberalization in Colombia was accompanied by an increase in the size of the informal economy. “[I]ncreasing informal employment is inherent to the current global economic restructuring.”²⁰³ The expansion of the informal sector might readily be linked to the implementation of the trade-opening policies of the 1990s, including the Washington Consensus.

202. WORLD BANK, *Doing Business*(2009), at <http://www.doingbusiness.org/>. .

203. PERRY, et al. at vi.

It should be noted that some authors have found weak linkages between the implementation of the Washington Consensus and reduced economic growth. Mauricio Cardenas, for instance, found that Colombian growth slowed in the 1980s, before the reforms of the Washington Consensus were instituted.²⁰⁴ Many of these authors do not consider, however, the effect of labor market and trade-oriented reforms on the informal economy, which substantially expanded in the 1990s and which is linked to growing inequality and poverty. Because more than half of the Colombian economy operates in an illegal, unregulated marketplace, reforms that open opportunities for foreign imports and increased competition in the formal sector also exert downward pressure on wages and curb formal employment opportunities. Thus, while the economy may have been on a downward swing when the Washington Consensus reforms were implemented, it was the reforms that opened the door to the expanding gap between rich and poor, causing more lasting damage than the economic downswing itself.

The laws passed in Colombia in the early 1990s that liberalized trade also increased competition, lowered the cost of factor inputs, and improved technology. All of these secondary effects are consistent with a decline in formal employment and a growing informal sector due to a decrease in demand for labor.

Goldberg and Pavcnik contend that there are no clear linkages between trade liberalization and the scope of the informal sector.²⁰⁵ They find that the Brazilian informal sector was reduced in size during the period of trade liberalization identified by Goldberg and Pavcnik, whereas that

204. MEJIA. at 4.

205. GOLDBERG & PAVCNIK. at 30.

of Colombia remained stable.²⁰⁶ While their study is comprehensive and interesting, the results are ultimately unconvincing. Goldberg and Pavcnik base their definition of trade liberalization on tariff reduction alone rather than examining the level of imports (which is the actual effect of tariff reductions).²⁰⁷ Yet even when considering tariff reductions, they find a growing informal sector in Colombia prior to the 1990 labor law reform that eased the firing of workers,²⁰⁸ and a smaller increase post-1990 reform.²⁰⁹ Thus, even using a measure that may not accurately reflect the amount of increased trade Colombia experienced in the survey period, Colombia's informal sector was still found to have expanded between 1984 and 1994.

Despite the aggregate growth of the Colombian economy, poverty reduction has slowed, inequality has not improved, and the informal sector has grown. A recent issue of the Colombian weekly news periodical *Semana* featured several articles on the state of poverty in Colombia. One such article highlighted the fact that poverty had been steadily reduced between 1978 and 1995, when the Colombian economy was growing at a rate of 4% annually and unemployment remained below 10%. During this period, the number of Colombians in poverty dropped from 45% to 21% of the total population.²¹⁰ As the economy slowed after 1998, poverty increased in Colombia, reaching 57.5%.²¹¹

206. Id. at 5.

207. See generally Id. By applying a tariff reduction measure, changes in the actual levels of imports could be miscalculated because it does not take into account the existence of non-tariff barriers, tariff peaks for processed goods, tariff dispersion and existing trade agreements that may have already provided for a lower entry rate.

208. REPUBLIC OF COLOMBIA, Ley 50 (Diario Oficial de Colombia ed., 1990).

209. GOLDBERG & PAVCNİK. at 29–30.

210. , *¡Pobre país!*, La Semana 2006.

211. Note that this is the number of people below the domestic poverty line and not the number living on less than \$2 per day. The number of Colombians below the domestic poverty line dropped 20% between the 1980s and early 1990s, reversing this trend and reaching its 1988 level again in 1999. The rate is approximately 57.5% of the population today. See Colombia Poverty Report. (2002).

Consider the linkage between trade liberalization and poverty the *Semana* article above suggests. World Bank statistics support this perspective, showing that while trade liberalization has expanded, the fight against poverty has weakened substantially (see **Error! Reference source not found.** below).

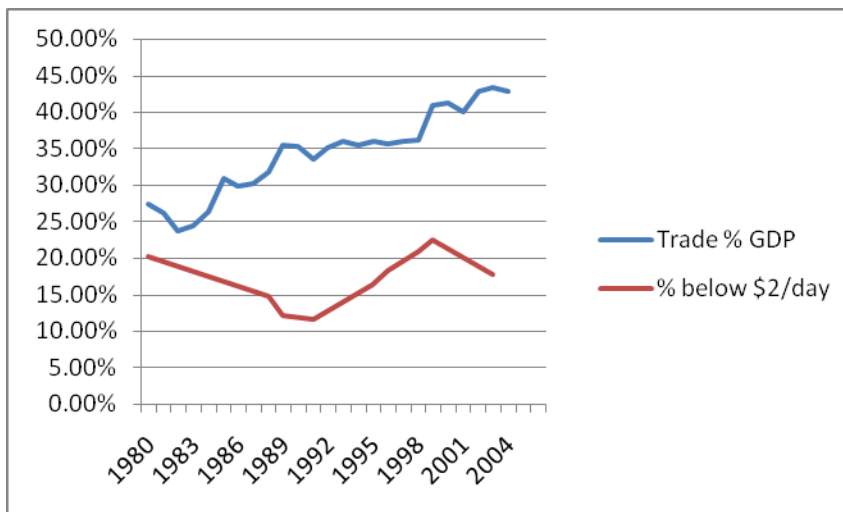


Figure 11. Trade as a percentage of GDP in Colombia; Colombians living on less than \$2/day.

Source. World Bank Development Indicators database.

It is also clear that aggregate economic growth in Colombia has been declining since its peak of over 8% in the late 1970s. Accordingly, while trade has expanded and GDP per capita has risen slightly, the Colombian economy's growth has slowed down, and has even been negative for some periods over the last twenty years.

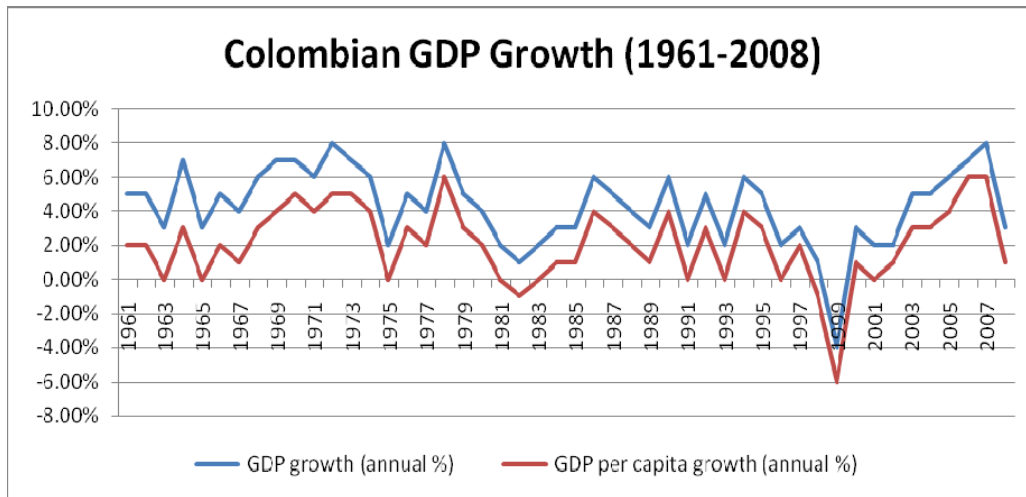


Figure 12. Colombian GDP Growth (1961-2008).

The slowdown in Colombian growth should come as no surprise to economic development analysts. With the recent downturn in the U.S. economy, demand for foreign imports in the U.S. has significantly declined. As Colombia's export economy is largely linked to the U.S. import economy, this has had a severe effect on Colombia. Also, because many of Colombia's exports are primary commodities—petroleum, coffee, nickel and coal—world market prices fluctuate extensively and can cause the Colombian economy to experience waves of growth, rather than consistent growth.

Despite the fact that Colombia's political economy has been stable, that it has not experienced the major debt or financial crises that many of its neighbors suffered, and that it has substantially liberalized trade over the last 19 years, Colombia has not yet developed a dynamic economy. A study by its own National Planning Department said that Colombia has not accelerated its dynamism since the late 1970s. It implies that the domestic business community

has not yet adapted to the global trading environment and has failed to concentrate production in port cities and on further industrialization of the economy.²¹²

The role of the informal economy in the export economy is limited as practically no unregistered firm participates directly in exportation. However, the informal economy has been targeted as one of the sources of economic stagnation that has held Colombia back from achieving its full production potential on world markets. This belief has led the Colombian government to take aggressive steps to curb the growth of the informal economy, as I discuss in the following chapter.

212. Programa de estudio La industria de América Latina ante la globalización económica. (1998).

Chapter 7: Colombian Approaches to Formalization

The informal economy in Colombia has long been recognized as a potential drain on economic development. Seen initially from a dualist perspective, whereby it was thought to exist alongside but disconnected from the modern economy, the informal economy in Colombia continues to be seen as a release valve for the approximately 14 percent unemployment rate in Colombia.²¹³

As early as 1980, the Colombian National Planning Department proposed plans to formalize the informal economy. Their approach, known as the “Plan to Close the Breach”, included intermediary finance, technology transfer, legal changes to favor small businesses, and efforts to promote small business associations.²¹⁴

The formalization efforts continue today and are largely modeled on the theories of Alejandro Portes and the McKinsey Group, each of which look at productivity and the structure of the economy to determine policy approaches.²¹⁵ Portes challenged the idea that informality will dissipate with capitalist development. He argued that it was this disregard for small enterprise and regulatory liberalization that contributed to a growing informal economy in the

213. See, e.g. , *Tasa de desempleo en Colombia ascendió del 13,1 al 14,2% en enero del 2009*, Portafolio 2009.

214. MANUEL ALVARO RAMIREZ ROJAS & JESUS ANTONIO SUAREZ ROSALES, *El Sector Informal Urbano en Colombia y las Políticas de Empleo, 1970-1980: Análisis de los Planes y Programas de Desarrollo y la Informalidad Económica 75-80* (Ediciones Tercer Mundo. 1985).

215. See FANDL, Interview with Alexandra Díaz Montenegro, Formalization Coordinator, Vice Ministry of Business Development, Ministry of Commerce, Industry and Tourism. (on file with author).

first place as small enterprises were pushed away from participation in an economy geared toward industry and export.

The McKinsey group takes the logic of Portes further by arguing that the government's disregard for facilitating small business development contributed to the growth of the informal economy. In their estimation, high corporate taxes and substantial bureaucracy forced many firms out of the formal economy. The reason some states have done this, according to the Institute, is to fund social programs that work to alleviate poverty and unemployment. This, in turn, has led to a disincentive to formalize and a spreading culture of informality. According to the Institute, the best solution for a developing country facing high informality is to streamline tax systems, remove the benefits of informality, and crack down on law violators.²¹⁶

State Efforts to Formalize

In alignment with these economic approaches to reducing informality and promoting economic growth, Colombia has moved toward the streamlining of business registration and taxation, while devoting limited resources to increased enforcement mechanisms. Colombian business entities are defined by law 590 (2000), as amended by law 890 (2004), which separates them into three groups. Microenterprises consist of no more than ten workers. Small enterprises have between 11 and 50 workers. And large enterprises employ more than 50 workers. Following this definition, Colombian microenterprises constitute 94.3 percent of all enterprises, with small and large enterprises constituting 4.6 percent and 1.1 percent,

216. See, e.g., FARRELL, *Tackling the Informal Economy*. see also, SANTIAGO LEVY, *Good Intentions, Bad Outcomes: Social Policy, Informality, and Economic Growth in Mexico*, (2008).

respectively.²¹⁷ According to the definition of informality asserted by Mauricio Cárdenas and Mejía, which states that informality is defined by a lack of business registration, approximately 41.1 percent of all microenterprises in Colombia operate informally. However, it should be noted that the definition officially adopted by Colombia for informality includes all small businesses employing ten or fewer people, including independent owner-operators (except for professionals), regardless of whether they are registered with the state.²¹⁸ The definition adopted by the DANE in Colombia is more appropriate for defining the small business sector, whereas the Fedesarrollo definition more closely resembles that adopted by the International Labor Organisation.²¹⁹

Informal firms appear to be the bulk of economic activity taking place in Colombia, but they are not always considered to be the driving force of innovation. According to Santa María and Rozo of the Inter-American Development Bank, the vast majority of new product production (71 percent), innovation (71 percent), organizational change (73 percent) and technology investment (78 percent), come from formal firms.²²⁰ Of course, the fact that informal firms are able to find a home for their business in the populated Latin American marketplace may be

217. MAURICIO SANTA MARIA & SANDRA ROZO, *Ininformalidad Empresarial en Colombia: Alternativas para Impulsar la Productividad, el Empleo y los Ingresos (Firm Informality in Colombia: Alternatives to Stimulate Productivity, Employment, and Investment)*, Inter-American Development Bank Working Paper (2008). (Informal Enterprise in Colombia: Alternatives to Stimulate Productivity, Employment, and Investment), Inter-American Development Bank Working paper No. 40 (March 13, 2008).

218. Colombia has adopted the definition put forth by the Programa de Recuperación de Empleo en América Latina y el Caribe (PREALC) (1978), which defines informality in this way.

219. According to the ILO, “The term “informal economy” refers to all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements. Their activities are not included in the law, which means that they are operating outside the formal reach of the law; or they are not covered in practice, which means that – although they are operating within the formal reach of the law, the law is not applied or not enforced; or the law discourages compliance because it is inappropriate, burdensome, or imposes excessive costs.”

INTERNATIONAL LABOUR ORGANISATION, *Resolution concerning decent work and the informal economy* (ILO Regional Office for Asia and the Pacific ed., 2002).

220. MARIA & ROZO, 12.

innovative in itself. And the savings generated by informal labor and inputs into formal firms may be a driving force behind their ability to innovate. De Soto characterizes informal firms as the epitome of capitalist development, applying creative energy and hard work to their business in order to survive.²²¹

Because of the important role that microenterprises play in Colombia, the state has focused extensive resources on small business promotion. Law 590 (2000) creates a benefit system for microenterprises that provides them with a 75 percent tax discount during their first year of operation, 50 percent for the second year, and 25 percent for their third year. This law, also known as the *Microenterprise Law*, is promoted by the Ministry of Business, Industry and Tourism (*Ministerio de Comercio, Industria y Turismo*). This law was only implemented very recently via Decree 525 of 2009.²²²

Law 590 is intended to promote the development of microenterprises by creating a more favorable environment for their formation and production. Among other things, this law requires that small firms (less than ten employees) receive preference for government contracts and simplified processes for payment of taxes. The law also establishes the *Fondo Colombiano de Modernización y Desarrollo Tecnológico de las Micro, Pequeñas y Medianas Empresas* (The Colombian Fund for the Modernization and Technological Development of Micro, Small and Medium-sized Firms) (Fomipyme). This institution is meant to facilitate the finance of small businesses through mechanisms such as the *Fondo Nacional de Garantías* (National Guarantee Fund), which provides insurance to banks that finance small businesses.

221. See, e.g., SOTO, 118.

222. COLOMBIA, Decreto 529 (2009).

One of the major facets of microenterprise promotion in Colombia is the provision of access to credit. This process is carried-out by another federal agency, the National Guarantee Fund (*Fondo Nacional de Garantías, S.A.*) (“FNG”). Their role is to provide access to credit for micro-, small-, and medium-sized enterprises, by granting loan guarantees.²²³ The number of loan guarantees that FNG has provided since its inception has increased substantially.

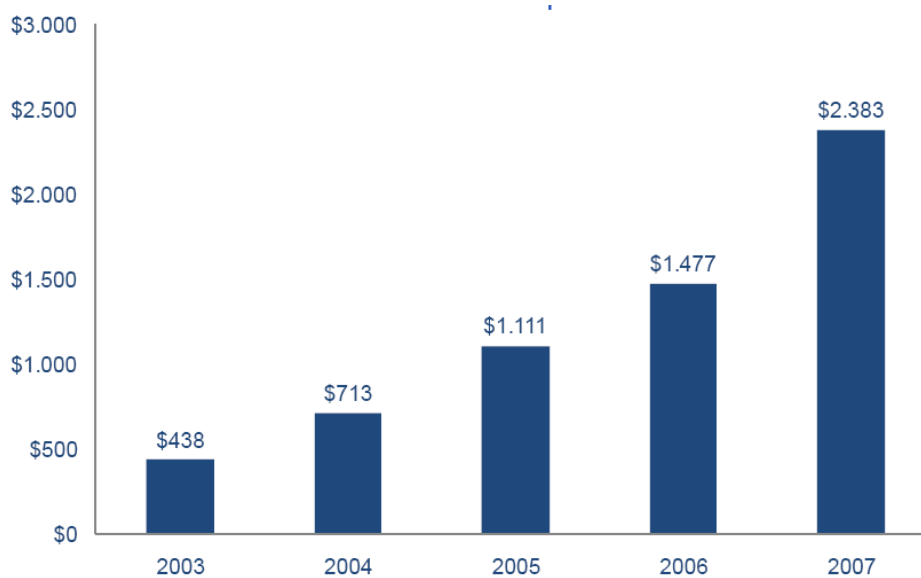


Figure 13. Annual Disbursements with an FNG Guarantee (in millions of dollars).²²⁴
Source: FNG Presentation (2008).

According to the Ministry of Commerce, Industry and Tourism, informality is one of the barriers to the creation of a competitive Colombian economy.²²⁵ The three pillars to the achievement of a productive economy that they identified in 2007 are the creation of small

223. S.A. FONDO NACIONAL DE GARANTÍAS, *Respaldamos el Acceso al Crédito*(2009), at <http://www.fng.gov.co/fng/portal/apps/php/index.kwe>.

224. MAURICIO BELTRÁN SANÍN, *El FNG como política estatal de apoyo a la mipyme y otros sectores* (2008).

225. See, e.g., INDUSTRIA Y TURISMO MINISTERIO DE COMERCIO, REPÚBLICA DE COLOMBIA, *Plan Estratégico del MCIT: Estrategia de Formalización Empresarial (Strategic Plan of the Ministry of Commerce, Industry and Tourism: Strategy for firm Formalization)*, (2007).

businesses, increasing the productivity of those businesses, and the formalization of firms.²²⁶

They identify formalization as a national priority for Colombia and set a goal of creating 145,350 small firms per year through 2010 and reducing informality each year.²²⁷

The approach of the Ministry is to seek formalization of all small businesses in an effort to help them become more productive. Through formalization, the business will be able to realize its potential as a successful entity by gaining access to government credit programs, trainings and interaction with similar businesses in the chambers of commerce, and the ability to advertise and operate publicly without fear of reprisals.

In addition to the Vice Ministry, numerous other state agencies work to relieve certain aspects of the growing informal economy. In 2008, a committee was formed to unite these various entities and to seek unified solutions to the problems associated with informality. Represented on this committee were the Bank of Opportunities, the Private Council on Competitiveness, Confecamaras, the Presidential Council on Social Action, the tax and customs agency, the Ministry of Housing and Public Credit, the National Planning Department, the National Learning Service (SENA), the National Statistics Agency (DANE), the Ministry of Social Protection, the Ministry of the Environment, Living, and Territorial Development, the Corporation for the Development of Microenterprise, the Association for Small Industries, and the National Federation of Commercial Sellers.

All of these groups were led by the Vice Ministry toward the development of a national plan of action, which includes 17 tasks directed toward the reduction of the informal economy. These tasks include changes in the law, new national policies, and national resolutions. The

226. Negociaciones en Curso. (2007).

227. MINISTERIO DE COMERCIO, *Plan Estratégico del MCIT: Estrategia de Formalización Empresarial (Strategic Plan of the Ministry of Commerce, Industry and Tourism: Strategy for firm Formalization)*.

action items center around microenterprise promotion through simplification of the tax system, support of microenterprises in their first years of operation, reduction of the costs to register and operate a small business, information sharing, enforcement of tax laws, and revision of census information.²²⁸

The Committee, formed by decree 2828 in 2006 in an effort to unify formalization approaches by various government and private entities, released its report on advances and strategies in the formalization process in Colombia in June 2009.²²⁹ The report follows the World Bank Doing Business approach closely, highlighting Colombian efforts to reduce taxes on small businesses, reduce the number of steps to become legal, simplify business laws and regulations, create a bankruptcy law, and market the benefits of formalization.²³⁰

The formalization coordinator for this committee within the Ministry explained that over-taxation is the basis for Colombian informality, and that improvement in productivity is the goal of the formalization process; thus, reducing taxes and streamlining registration could lead to the creation of more productive, formal firms.²³¹ The Ministry reviews laws and regulations to determine where inefficiencies exist in order to promote business development and to encourage formalization. Yet it is the chambers of commerce that engage in the direct contact with businesses, implementing the policies of the ministry.

Law 232 (1995) explains the requirements, in no uncertain terms, for operating a business in Colombia. The five requirements are: 1) follow the business norms set forth by the

228. El Conpes 3527 Work Plan. (2009).

229. REPUBLIC OF COLOMBIA, Decreto 2828 (Diario Oficial de Colombia ed., 2006). See also, REPUBLIC OF COLOMBIA, Acta de Creación del Comité Técnico de Apoyo a la Comisión Nacional de Competitividad, para la Promoción de la Formalización Empresarial (President's High Council on Regional Competitiveness ed., 2006).

230. Avances y Nuevas Estrategias (2009).

231. FANDL, Interview with Alexandra Diaz Montenegro, Formalization Coordinator, Vice Ministry of Business Development, Ministry of Commerce, Industry and Tourism. (on file with author).

municipality in which the firm is operating; 2) comply with existing sanitary laws; 3) maintain a current business license; 4) notify the planning office of the opening of the firm; and 5) for those firms that play musical masterpieces, follow law 23 (1982). These requirements are not very distinct from the requirements to form a small business in the United States, such as obtaining a tax identification number, acquiring a business license, complying with local laws, and paying taxes.

Clause 4 is the most relevant to our discussion. Clause 4 of Law 232 sets forth the punishment for a firm that fails to register their operation. If a firm fails to register, they will first receive a letter from the DIAN, the Colombian tax authority, requiring registration within 30 days. If they fail to comply, they will be fined significantly, and eventually, the DIAN will shut down their operation. Compliance is measured by taxation and by registration with the local chamber of commerce, which is discussed below.

Colombian Chambers of Commerce

Government agencies are assisted in their efforts by the various Colombian chambers of commerce. The chambers are private entities that are located in every major city in Colombia. They play a critical role in formalization because they were designated by the government as the sole entity that can collect registrations from businesses. Thus, rather than applying to register a business with a government agency, all coordination takes place through the chamber. Each chamber promotes business development by offering access to an array of similar business interests, promoting the activities of the business, and providing training for firm owners and employees.

Because of their importance in Colombian trade, the chambers are unified through a central body that advises them, known as the *Confederación Colombiana de Camaras de Comercio* (Confecamaras). This national entity, located in Bogotá, is responsible for coordinating policies and disseminating information about formalization to the chambers. Confecamaras provides training in many industries, guidance on engaging in international trade, and networks of related business interests throughout Colombia and the world. For a small business, they provide essential services. The fee to register a business with the chamber is based upon the initial capitalization of the firm, adjusted each year based upon profits. These fees fund the operation of the chambers.

Chambers of commerce are also engaged in formalization efforts. Because they collect and keep the fees for registering a business, as well as the annual registration fees, they have an economic incentive to seek new formal firms. For example, “Formalize now!” is the slogan of the Chamber of Commerce in Popayan, Colombia. Television commercials frequently appear in Bogotá encouraging small businesses to register with the state to take advantage of the benefits of formal operation. Loans from the Inter-American Development Bank work alongside state funding to chambers of commerce in many Colombian cities to stimulate business registration through the chamber.

Fedesarrollo and the Inter-American Development Bank

Two other actors are worth noting in the research and efforts to formalize in Colombia. Fedesarrollo is an independent think tank in Colombia that has several economists focused exclusively on informality. The lead investigator of the small business formalization unit, Maria Angelica Arbaláez, shared her concerns over the Colombian approach to economic development

through formalization. After collecting a wealth of data and conducting targeted focus groups of informal firms, it became apparent that no two informal firms are alike. While most informal firms are small, young, and driven by the basic income that the firm offers, each firm has different motivations for operating their business. These results will be discussed later.

Some small firms see no benefit in formalization because they are not driven to maintain a long-lasting or productive enterprise. These firms tend to survive on the small profits that they earn by avoiding taxation and registration fees and they benefit from the flexible work schedules and lack of reporting required in the operation of an informal business.

Other firms value what formalization would offer and would take advantage of it if they were confident that they would not experience a loss in revenue or stability, neither of which the state can guarantee. Accordingly, this investigator suggests that the state should recognize the need for a bifurcated approach to business promotion, and should concentrate their efforts on those small firms that desire formalization rather than on all small firms.²³²

On the multilateral level, the Inter-American Development Bank (IDB) plays a key role in financing Colombian formalization efforts. In its recently released 2007-2010 country strategy with Colombia, the IDB highlights the need for improving competitiveness of enterprises and of creating an enabling environment for business. It encourages a balance of pro-poor strategies and openness to international trade through competitiveness, social development, and strengthening of the state. The report specifically highlights the need to integrate informal businesses into the economy and set a target for firm informality of 29 percent.²³³

232. KEVIN J. FANDL, Interview with María Angelica Arbeláez, Associate Investigator, Fedesarrollo (2009). (on file with author).

233. Colombia: The Bank's Country Strategy with Colombia 2007-2010. (2008).

To carry-out their strategy, the IDB has initiated numerous projects aimed at business promotion and formalization in Colombia. These include a project in the region of Antioquia entitled, "Formalization of Small Businesses in the East Antioqueno Region", which intends to register small businesses, train small business owners about laws and tax obligations for running a small business, and helping small businesses renew their expired registrations.²³⁴ A similar project was approved in the city of Popayan, whereby the local chamber of commerce is funded to coordinate a program of formalization with the goal of registering 500 small businesses and provide them training in entrepreneurial topics.²³⁵ This project resulted in the production of a comprehensive report on the identification of informal firms and the process of formalizing them.²³⁶ Both projects are ongoing and results are not yet available.

Interview at Fedesarrollo, Bogotá

Fedesarrollo is a Colombian think tank oriented toward the economic development of the country. They are routinely contracted by the state to provide economic data and analysis of development projects and needs. The organization is independent and provides neutral, third-party advice to the state and other institutions. Within the organization, various research programs exist, each focused on a specific economic development goal. One such program is focused on the informal economy.

I met with a senior researcher in the small business program. She shared with me background information on what the state has been doing to facilitate a reduction or elimination in the size of the informal economy and its negative impact. She shared recent

234. Entrepreneurial Strengthening and Formalization to 500 Informal Businesses. (2008).

235. Entrepreneurial Strengthening and Formalization to 500 Informal Businesses. (20080).

236. Estudio de Identificación de Potenciales Beneficiarios del Programa Formalización (2009).

studies conducted by the Inter-American Development Bank, with which Fedesarrollo often partners, examining the extent of the formalization programs in the region. She also explained that her group recently conducted a focus group on informal businesses in the hotel and garment worker industries. This data significantly contributed to my own research by showing the segmentation within the informal economy related to the demand for formalization.

In carrying out their focus group analysis, Fedesarrollo interviewed a sample of home garment workers and small hotel operators. They asked them about their motivation for operating informally and their interest in participating in the formalization process being advocated by the state. Most highlighted their ability to work from home, where public services were cheaper than in a business location. The hotel operators suggested that they would have to formalize if they decided to expand as their operation, currently run out of their house (i.e., renting rooms) would be exposed. The textile workers indicated that they have consistent demand from formal firms that request their services. Neither indicated a desire to formalize, although some hotel operators were warm to the idea.

The conclusions that Fedesarrollo drew from this focus group were that informality is not a homogenous group of workers; it is largely survivalist; and that it is and will remain unproductive. Accordingly, they did not support the state's efforts to follow a unitary formalization approach. The researcher that I interviewed suggested letting informal firms be and focusing energies on the enhancement of formal firm productivity.

Interview at the Ministerio de Comercio, Bogotá

The Ministry of Commerce in Bogotá is a large and powerful state institution focused on facilitating the economic development of the country through small business growth and

entrepreneurship. Not surprisingly, considering the extent of informal small businesses, the Ministry has its own formalization office. Yet even outside of this program, the entire Ministry is focused on formalization.

I met with the director of the formalization program, who explained that the program in the Ministry arose directly out of a push by the state at the highest levels to find solutions to the problem of rising informality. The Ministry was tasked with analyzing the impact of laws and policies proposed by the government agencies that could impact the informal economy in any way. This small office reviews all proposals and provides analysis of the impact in order to inform the decision makers before they go forward with the changes.

According to the Ministry, the state sees informality as an outgrowth of rapid economic development that displaced a number of economically active workers. This aligns with the structuralist approach of Alejandro Portes, who the Director mentioned by name. Interestingly, she also mentioned that the state relies upon studies by the McKinsey Institute, which as I discuss below, approaches informality from the perspective that it is bad for business.

The reason that the state is so interested in formalization, according to the Director, is informal firms are unproductive, don't pay taxes, don't comply with regulations, and hurt formal business competitiveness. If these firms were formal, she argues, they would have access to all the support programs of the local chambers of commerce, access to loans from the microenterprise loan program of the state (Fomipyme), and would have access to financial support from the private sector. Because such a large percentage of small firms are informal, the state sees the enhancement of their productivity through formalization as a central goal in their economic development policy.

The Ministry is not directly involved in the formalization process. Most programs that work directly with firms are privatized, such as those offered through the local chambers of commerce. The Ministry addresses macroeconomic initiatives, laws, and policies that align with the administration's goals. The Ministry believes that allowing the private sector to coordinate the formalization process is a more efficient use of resources.

This interview crystallized the approach of the Colombian state toward the informal economy. The state maintains that informality is equivalent to unproductivity and that formalization is a necessary step to productivity. As I explain in section III, there are a number of concerns with this approach and its potential for success is very limited.

Interview with Mauricio Cardenas, Washington

Former Colombian Minister of the Economy and Director of Fedesarrollo Mauricio Cardenas is now a senior fellow at the Brookings Institute in Washington. I met with him to discuss his impressions of the Colombian informal economy. I met with him in 2009 to discuss his impressions of the Colombian small business and informal economy.

Cardenas explained to me that one of the most significant economic problems facing Colombia today is the ability to collect sufficient tax revenue from business. Currently, Colombia maintains a single rate business tax at 33%. Many small and nearly all informal firms avoid paying taxes either because the risk of penalties is very low or because they do not earn enough revenue. The tax enforcement agency, the DIAN, has limited enforcement resources and faces a challenging enforcement effort in many urban regions of Colombia due to security risks and community protest against taxation. As small firms make up the bulk of business in Colombia, the state is left to depend upon the roughly 2,000 large firms to supply the entirety of

its tax revenue. However, in order to attract these firms to their cities, many large firms receive tax incentives that further reduce the state or locality's revenue. Thus, the state needs to maintain a high tax rate to cover their necessary expenses, at the risk of losing potential businesses that are deterred from operating legally by the high tax rate.

According to Cardenas, Colombia is interested in reducing informality not to collect more tax revenue alone, but also to improve productivity and spur economic development. However, as Cardenas readily concedes, the linkage between formalization and productivity is unclear, making a formalization approach based on the desire for productivity gains somewhat risky.

Cardenas also discussed the recent creation of Centros de Atención Empresarial in major Colombian cities, which, as I mentioned earlier, tend to the needs of small businesses and offer advice on how to formally register an enterprise. While not necessarily a solution to informality, Cardenas contends that the focus should be on capitalizing on the firms that want to be more productive but that do not know how by sharing information and opening the door to registration, loans, and a community of productive small firms.

Interview with Ministry of Antitrust, Bogotá

One contact that reached out to me after learning of my research was an attorney from the Colombian Antitrust Ministry. She works in the consumer protection department handling agricultural goods. After explaining the role of her agency and their interaction with informality, she shared with me details about a specific case involving the informal market for raw milk (leche cruda), a significant and often dangerous market.

As I discuss this case later in the thesis, I will only summarize here. Raw milk is a hot commodity because it supplies cheese producers and others that use milk as an input with low-cost milk. The government disfavors raw milk, although it has not yet outlawed it due to significant protests from the industry. However, it has regulated it through a system of pricing based upon lab testing for fat content, solids, and bacteria. Theoretically, producers of milk will be able to fetch top dollar for higher quality, filtered milk.

Yet the costs of testing are high and may not be worth the effort for some. So, informal milk buyers falsify tests (they usually do not have labs to test the milk) and purchase and sell the milk more cheaply because it is not filtered milk. These milk products go into the production of Colombian goods such as cheese and arepa (a corn-based pancake), which are then sold at lower cost on street corners and in informal shops.

Efforts to crack down on this behavior by the Ministry were met with significant resistance. Those few middlemen that the Ministry identified through their registration indicated that increased enforcement of the law would force them back into informality, along with the many other informal middlemen currently operating in this industry. This led the Ministry to withhold any effort to prosecute the raw milk middlemen.

In my discussions with this representative, I found very interesting her perspective on enforcement of the law prohibiting the operation of unlicensed firms. The principal problem faced by enforcement agencies, such as the DIAN, is the insecurity found in areas in which informality is common. Community unity and often violent retaliation can result from any effort to force street vendors or small shops to begin paying taxes or register their business with the DIAN. Accordingly, enforcement is highly limited, if only to protect the enforcers.

Interview with the Cauca Camara de Comercio (Chamber of Commerce), Popayan

One of the principal projects that I investigated while in Colombia was an Inter-American Development Bank funded formalization project in the city of Popayan in the Colombian department of Cauca. Details of this project are included later in this thesis. The project is coordinated in Colombia by the Cauca Chamber of Commerce, located close to the west coast of the country. I spoke with an attorney that works with the public registration section of the Chamber of Commerce about the formalization project in Popayan.

The attorney that I spoke with assists small informal businesses that want to formalize by providing them with instructions and guidance on the process of obtaining a registration number and complying with tax and regulatory laws. She informed me that the Chamber and the state are working to reverse the trend toward growing informality by simplifying the registration process for new businesses and expanding access to information about formalization through the establishment of centros de atencion empresarial (CAE), which are special attention centers for potential small businesses to gather information about the registration process.

In my conversation with this attorney, I learned that most of the natural persons and associations that come to her to formalize don't know anything about formalization, the process of registration, or the benefits of being formal. Most are interacting for the first time with the chamber of commerce when they come to register their business. She indicated that most businesses that decide to formalize do so to take their firm to the next level through increased access to financial support.

According to this attorney, there is no disinterest in formalization; only a lack of awareness of the formalization process and its value—informal firms should formalize, and formal firms should abide by their obligations under the law, including taxation, accounting practices, annual registration renewal, and so on. For this reason, she believes that the best mechanism to reduce the growing trend toward informality is to spread awareness through programs such as the CAEs, which can make it easier for informal firms to see and understand the registration process.

Interview with Formalizate, Popayan

I learned about the formalization project in Popayan through a contact at the Inter-American Development Bank in Washington, D.C. I spoke with the representative of the Bank in Popayan, who directed me to the project director, Maria Eugenia Solarte. The Formalizate project in Popayan arose out of Colombian law 232 (1995), which explains the process of starting and running a business in Colombia. An expansion of the informal business community is indicative of a failure to fully realize the application of this law. To reverse this trend, the Cauca Chamber of Commerce, with the help of grants from the Inter-American Development Bank, initiated the Formalizate project with the goal of formalizing and strengthening 500 small informal businesses in Popayan.

The project is only in its initial stages, so no actual formalizations have yet taken place. However, the Director explained to me that there is significant interest from the state in the success of this project as it may serve as a model for similar projects in other cities. She sent me the preliminary project plan, which explains in no uncertain terms that informality is a drain on

the economic development of a community and that formalization is the best way forward to promote growth.

The project began based upon a national initiative to increase productivity and competitiveness of industry nationwide. The Cauca project is intended to strengthen and formalize 500 businesses in the city of Popayan over the next two years. An initial survey was conducted by the project that identified 1,784 small, informal firms. According to the survey, 96% of these firms expressed a willingness to formalize in exchange for lower tax rates, access to microcredit, and simplification of the registration process.

Success of the Formalization Projects

Evidence of the success or failure of any formalization project will be anecdotal as there are generally no statistics gathered during business registration on prior business activities outside of the formal sector and ongoing projects in the region have no demonstrative data. Yet the ultimate goal of formalization is not to shift informal firms to the formal economy alone, but rather to reduce the incidence of informality altogether. This is evident through the state's approaches to formalization, including tax simplification, ease of business registration, and increased enforcement of tax laws and registration.

According to the Formalization Division of the Ministry of Commerce in Colombia, the goal of formalization is to facilitate business development and increase the productivity of firms. They begin from the theory of Alejandro Portes, which suggests that the informal economy results from the advent of capitalism and that informal firms arose to meet the demand for cheap labor, cheap inputs, and supplies without the added costs of regulated business.

Following the logic of Portes, the focus of formalization should be on the laws and policies that affect economic transactions. Firms operate informally because it is too complicated and expensive to operate formally, and if they are already formal, they may depend on supplies and inputs from informal firms that produce goods and provide services at lower cost than formal firms. Rather than seeing informality as a unique phenomenon, as per Loayza, for instance, informal firms should be seen as a part of the dynamic economic development of the country.

Colombian formalization projects focus on the facilitation of business development. They attempt to incentivize formalization by making the operation of business easier, the costs of registration lower, and the benefits of being formal more substantial. A formally registered firm has access to the local chamber of commerce, which is a private enterprise in itself, to receive training, advertise their wares, and access broader markets. They also have access to state funding through programs such as *el Fondo Colombiano de Modernización y Desarrollo Tecnológico de las Micro, Pequeñas y Medianas Empresas* (FOMIPYME), which provides funds for microenterprise projects and activities, including their technological development and business promotion.²³⁷

The basic idea behind Portes' assessment is that in order to reduce the size of an informal economy, a country should design policies that are conducive to business development and growth, and avoid laws that overly restrict entry into the formal marketplace. This view is an effective approach to the formalization of certain small businesses, but may not be applicable to a significant number of Colombian small enterprises. Following on the work of Fields and

237. See, e.g., MIPYMES PORTAL EMPRESARIAL COLOMBIANO, *Instrumentos de Apoyo: FOMIPYME*(2007), at <http://www.mipymes.gov.co/microempresario/newsdetail.asp?id=291&idcompany=45>

Maloney, there is increasing evidence of an internal duality in developing country informal economies, in which some firms are economically motivated to “exit” the formal economy and take advantage of the lower costs of operating informally, while others are running businesses only for survival, and not for the traditional economic rationale of maximizing profits.

Recent studies conducted by *Fedesarrollo* shed light on this internal duality in Colombia. Using a psychologist to interview samples of firms in the hotel and apparel sectors, *Fedesarrollo* discovered that most informal firms have no interest in formalizing, finding it to be expensive and unnecessary. An apparel firm, for instance, has no interest in expanding out of her home into formal business space, which is more expensive for utilities and taxes, nor in paying an annual fee to the local chamber of commerce to be registered, nor in having to comply with labor laws if she has employees. In the hotel sector the result was more mixed. Individuals that rent out a room in their house for a night occasionally have little interest in registering themselves as a business and paying taxes on their profits. Yet a firm that rents out multiple rooms or units on a more regular basis may find the access to advertising through the chamber of commerce to be worth the registration fees and taxes.

The conclusion of the *Fedesarrollo* research is that, while the informal economy is indeed dynamic in parts, broad generalizations about the desire to operate formally are premature. There appears to be a division between firms that use informal business as a means of basic income, and those that have an interest in developing a successful enterprise, no matter how small or productive. This is a very important finding as it challenges us to rethink the formalization approach and perhaps to construct a new model to remedy the negative implications of the informal economy.

For the formalization of firms to succeed, the firms need an incentive to join the formal economy. Often, this incentive is economic - increased productivity, access to credit, and business training and resources through the local chambers of commerce. Yet these economic benefits are rarely the principal wish of every informal firm. These economic incentives are not subsidies that would immediately facilitate an increase in revenue for the firm, nor would they help the firm to meet the basic needs of the owner and their family. Rather, these benefits provide opportunities for business growth, investment in new capital assets and technology, and training in business acumen. A firm that is motivated to grow into an effective small business and to expand its operation, will see the benefit in these incentives and, given the right package, may formalize.

However, a firm that is interested in maintaining only the most basic services, working to survive, and taking advantage of the flexibility that independent and unregulated operation offers, will have little reason to seek these long-term, productivity-oriented economic incentives. An independent taxi driver that makes her living on the fares that she collects throughout the day and that relies on the flexibility of having a vehicle and no set schedule has little interest in formalizing her business. An ice cream vendor that receives his supplies from a formal supply firm and that earns the difference between what the formal firm charges him and his markup on a hot day is unlikely to see any incentive in paying taxes and annual business registration fees. Some vendors may not even be able to register their business because they would have to comply with certain regulations that would raise the price of their goods and eliminate their market. This is the case for cell phone minute vendors and raw milk buyers, for instance.

Accordingly, Colombia needs a multifaceted approach to formalization. To address the negative externalities associated with the “survival-oriented” firms, Colombia may need to develop a new package of incentives that address their unique needs in exchange for their registration and willingness to comply with necessary regulations, as I discuss in part IV.

Looking at formalization through the regulatory lens in Colombia is also insightful. The Colombian equivalent of the U.S. Federal Trade Commission, the *Superintendencia de Comercio*, explained that for them, formalization is valuable because it allows them to identify and regulate industries that could pose risks to consumers. One particularly important case under examination in Colombia presently is the sale of raw (non-pasteurized) milk. The government has attempted to outlaw the sale of raw milk by regulating the production of the milk and requiring that it be tested for bacterial content before it is sold to distributors. The price of the milk is determined by the results of the bacteria test. However, informal middlemen, who are responsible for conducting these tests, buy raw milk from producers and falsely certify that it has been tested (most do not even have testing labs), in order to sell it at a more competitive price to distributors or consumers. This milk ends up in the production of other products, such as cheese, keeping the prices of those consumer goods low despite the risk that they contain harmful bacteria.²³⁸

The milk case also provides valuable evidence of the fragility of the formalization process. Some middlemen in the milk industry choose to formalize, possibly to take advantage of access to government credit or larger distribution networks. These formal middlemen are often the only visible elements of the raw milk industry and tend to be the target of government

238. KEVIN J. FANDL, Interview with Aura Maria Londoño, Economist, Colombian Superintendencia de Comercio (2009). (on file with author).

investigations into the raw milk industry. They are sometimes threatened with prosecution for their role in selling the untested milk to distributors. However, these middlemen have told regulators that they could easily disappear back into the informal economy if the government continued its prosecution of informal firms only and that for every formal middleman there are ten informal middlemen averting regulation. The possibility of prosecution of formal firms that work within an informal network, then, creates a disincentive to formalize (or remain formal).

Urban Formalization Programs in Colombia

In recent years, Colombia has aggressively pursued traditional formalization strategies through internal government policies and through joint public-private partnerships with chambers of commerce, local governments, and the Inter-American Development Bank. The Ministry of Commerce, Industry and Tourism's formalization committee was established at the behest of the Colombian President, reflecting the importance of a coordinated effort to reduce the growth of the informal economy. The committee is led by the Ministry of Commerce, Industry and Tourism and is responsible for reviewing, modifying, and creating policies that promote formalization; however, they do not engage in the legalization process directly.

The state delegates this authority to Colombia's powerful chambers of commerce, which exist in every city. The chambers are private entities that are responsible for business promotion, training, and coordination. The chambers follow the procedures established by the state to register new businesses and keep the revenues from these registrations for themselves. In effect, the chambers are the practical facilitators of the formalization process in Colombia. While each municipality maintains a chamber, a central chamber of commerce, *Confecamaras* or Confederation of Chambers, coordinates the general policies of each local chamber. The

strategy of Confecamaras is “formalization across the nation in order to be able to increase productivity.”²³⁹ Two examples of powerful chambers and their formalization efforts are below.

The Cauca Chamber of Commerce

One of the most aggressive formalization campaigns in Colombia takes place in the municipality of Cauca, centered around the hot city of Cali, where the Chamber of Commerce has created the “Formálzate” initiative. The strategy of this effort includes the following elements: 1) reduce the costs of intermediaries; 2) expand the presence of information centers about formalization; 3) diffuse the firm’s services; 4) publish information about the costs and benefits of becoming formal; 5) produce information that explains the steps to formalization; 6) provide consulting services to help promote the firm; 7) offer informal firms rebates on the costs of formalization, such as registration with the Chamber of Commerce; 8) register newly formalized firms with the “Emprenda la RUTA Microempresarial” program, which helps them with financing, taxes, and quality improvements; and 9) implement campaigns in areas of high informality to create awareness of the costs of informality.²⁴⁰

The Inter-American Development Bank injected \$150,000 into this chamber of commerce to facilitate their efforts to formalize small businesses in Cauca.²⁴¹ That project has the stated goal of formalizing 500 microenterprises and training those owners in entrepreneurship. The underlying motivation of the project is to “fight against disloyal competitiveness generated by the presence of informal business.”²⁴² As of the time of this

239. IDB.(describing the joint IDB/ Popayan Chamber of Commerce formalization project).

240. MARIA & ROZO, 26.

241. IDB.

242. Id.

thesis, only stage one of the project was completed – mapping the potential beneficiaries of the project. This report identifies 1,784 informal microenterprises in Cauca working in a range of activities from restaurants and hotels to transport and communication.²⁴³ The vast majority (53.3 percent), however, are *comerciantes* or merchants. Most (37 percent) of these firms earn less than \$250 per month and more than half already have access to some type of credit arrangement. Nearly 60 percent of these firms are run by women. The next phase of the project is to sensitize the firms to the benefits of legalization.

The formalization efforts in Cauca, as in other parts of Colombia, rely upon the theory that economic incentives such as tax discounts and access to credit, will convince informal firms that it is more advantageous for them to operate formally. However, most of the firms that the Cauca chamber identified will likely fall within the two types of informal firm described above, namely, those that were already planning to voluntarily formalize and those that may capitalize on the economic incentives to temporarily relocate to the formal economy without making any practical change in their operating framework. In either case, the formalization project may have a less significant impact than hoped on reducing the size of the informal economy.

The Bogotá Chamber of Commerce

Following the lead of Cauca, the capital city of Bogotá began their own campaign to formalize through their chamber of commerce. Their campaign, noted by the slogan “Formalizarse Paga” (Formalization Pays), focused on neighborhoods with high informality – largely poor neighborhoods (Chapinero, Kennedy and Ciudad Bolívar).²⁴⁴ The goal of the

243. Estudio de Identificación de Potenciales Beneficiarios del Programa Formalización. (2009).

244. MARIA & ROZO, 27.

chamber is to sensitize 70 percent of firms identified as informal in the business census, localize formalization programs within neighborhoods with high concentrations of informal activity, formalize 20 percent of the informal firms in the Chapinero and Kennedy neighborhoods, and develop at least ten new partners in the formalization process.²⁴⁵

Bogotá faces a significant challenge with respect to formalization as they have an informal sector of over 60 percent of the more than six million inhabitants of the city.²⁴⁶ Like in Cauca, the vast majority of informal business activity in Bogotá takes place in the commercial sector, including street vending, retail sales, and hotels and restaurants. The approach of the chamber in Bogotá is more diverse than that of Cauca, integrating both a direct formalization program in poor neighborhoods, and also an information dissemination program throughout the city. The direct formalization program is likely to face similar challenges to stable reductions in informal activity.

A relatively new approach to formalization initiated by the Bogotá chamber of commerce is the creation of the *Centro de Atención Empresarial* (Center for Business Attention or CAE).²⁴⁷ The CAEs are meant only to provide information to firms that want to learn about the legalization process. They explain the steps that the firms need to take to register their business, and the associated costs for doing so. These CAEs are located throughout Bogotá and are beginning to appear in other cities also.

However, the CAEs have the distinct advantage of offering information without liability for the firm. Former Minister of the Economy in Colombia Mauricio Cárdenas agrees that CAEs

245. Id., 27-28.

246. See, e.g., El sector informal en Santa fe de Bogotá, D.C.: Empleo, productividad y condiciones legales. (1997).

247. See, e.g., MEJIA.

are a more effective route to achieving voluntary formalization in large cities.²⁴⁸ The approach of the CAE is to forego broad formalization aimed at productivity gains in exchange for targeted, voluntary formalization that targets only those firms that have an interest in operating legally and improving their productivity. While not a comprehensive solution to the problem of informality, CAEs are a positive step toward an enabling approach to the informal economy in Colombia.

248. KEVIN J. FANDL, Interview with Mauricio Cárdenas, Brookings Institution Senior Fellow, Latin America Initiative Director (2009). (on file with author).

Chapter 8: The Colombian Response to Formalization

Trade liberalization and pressure from large business interests has led Colombia to take aggressive steps to formalize their economy. The desire to more broadly apply tax burdens, eliminate unfair competition, and promote health, safety, and intellectual property standards, has led Colombia's informal and small business community to bear the brunt of this reform effort. And with more than half of all Colombian small businesses, according to recent surveys by the DANE, unregistered, this is no small task.

In order to achieve the desired outcome, Colombia has passed laws requiring registration with the local chamber of commerce for all small business; created an agency that reviews new laws for their impact on informality; and funded programs such as the *centros de atención empresarial* that offer advice to voluntary formalizers. Chambers of commerce in various Colombian cities have initiated programs to market the benefits of formalization to their small business communities. And research agencies have provided extensive data on the extent of and rationale behind informality.

However, as rule of law scholars have asserted for years, top-down law and policy in developing countries is rarely equated with successful implementation on the street. Absent extensive resources poured into enforcement of registration laws, including agents working for the DIAN taxation authority, police, judges, and prosecutors, states must rely on voluntary

compliance with the law. And while an incentive-based approach will certainly convince a number of businesses to register, simple cost-benefit analyses combined with a lack of trust in the state suggest that these efforts will be unsuccessful.

This chapter, then, purports to show the Colombian firm's view of the formalization process. How do firms operate informally today and how do they perceive the efforts of the state to legitimize their business in the face of the law? The following interviews attempt to uncover the local attitudes toward this process and toward informality in general. The first interview, with a formal small business, attempts to put into perspective the type of economic actor that could benefit from formality.

Interview with Colombian small business owner, Bogotá

In an attempt to contrast the process of starting a small business in Colombia with resources and without, I met with the owner of a relatively new small restaurant in central Bogotá. He has a Greek background and thus began a restaurant selling gyros, which is quite popular in Colombia.

I asked the owner about his process for starting the business. He explained that the registration process was relatively quick and inexpensive, but that he needed the financial resources to pay the required taxes, registration fees, and insurance costs. He also capitalized on his graduate business education and loans from his family to purchase a storefront and supplies to start the venture. I asked him why he chose to formalize rather than to operate informally. He explained that the registration provides him with access to additional loans and freedom from harassment by the local police. However, he also said that he uses informal

suppliers to provide him with the inputs for his restaurant, such as the food and paper products. Much like many formal firms in Colombia, this owner cuts down on operating costs by leveraging cheap labor in the informal marketplace.

The desire of this restaurant owner to own his own business, make a profit, and apply his skill set, is not unique to the formal or informal business community. The difference lies in this businessman's education, access to financial resources, contacts in the business community, and economic class. These characteristics are far more common in the formal economy than in the informal economy.

Interview with a street vendor, Bogotá

On a busy street corner in downtown Bogotá, Melida squeezes fresh orange juice and serves mango with salt and other fruit mixes. She owns her own cart and supplies it with fresh fruit every day. She wakes at 2am in order to travel to the distant warehouse where area farmers come to sell their fruit. She takes the bus back to pick-up her cart and position it on the corner of a sidewalk in the middle of the business district. Another fruit vendor is situated directly across the street in a safer location on the sidewalk, a space that she earned after five years of operation there. Melida would not challenge her right to be situated there.

Melida hasn't always been an informal vendor. She previously owned a farm in rural Colombia. In 2003, Colombian guerillas invaded her land and forced her to grow coca that they would sell to finance their other activities. Fearing for her safety, she fled to Bogotá in 2004 and applied to the state for support as a displaced citizen. The state supplied her with food for a brief period but nothing more. Melida began working as a maid to earn enough income to

purchase fruits to sell on the street. As her income grew, she invested in a fruit cart, juicer, and a glass case to keep the fruit cups on display fresh.

In May 2009, a driver made a turn onto the street where Melida positioned her fruit cart and this car crashed into Melida's cart. When police arrived on the scene, the cart was in shambles and Melida had some minor injuries. All parties were taken to the hospital. With the encouragement of the police officer, Melida negotiated a settlement with the driver for the equivalent of \$350 to pay for the damages to her cart. This was enough to purchase her equipment again but not to buy more inventory. The farmers at the supply warehouse offered her credit based upon an oral contract to allow her to purchase more fruit. She repaid that debt three days later.

Melida wants to leave the street corner behind and relocate to a fixed storefront to avoid the hazards of working on a street corner and to avoid the neighbor's threats to call the police to remove her. But she does not have the means or knowledge of how to do so. She earns roughly \$250 per month, which is enough to pay for her supplies and for her children's school, but not enough to pay rent in a storefront. She would need access to credit and assistance with the formal process of establishing a storefront, including registering her business, completing tax registration forms, and complying with health regulations.

Much like the gyro restaurant owner, Melida has a dream of owning her own business and making it profitable. Yet with her lack of education, access to financial resources, and business acumen, she has a significant uphill battle to achieve that dream.

Interview with a Taxi driver, Bogotá

The streets of Bogotá are littered with small, yellow taxis. Some are part of cooperatives, or unions, while others work independently. Some operate with meters and others negotiate a fare with you at some point along your journey. Emilce is an independent owner-operator of a small taxi. She is one of only a few women that drive cabs in the city, but she is more aggressive than most male drivers and is never late for a pickup.

Emilce used to own a truck with her husband that she would drive between cities transporting goods. She earned a reasonable income and they raised their two children on the earnings of the business. A few years ago, her husband stole the truck from Emilce, sold it, and relocated to the United States with the money. Emilce was left with nothing but two hungry children.

In order to survive, Emilce began baking deserts in her mother's house and selling them on the street in front of the house. She used these meager earnings to purchase a food cart, which she continued to use to sell pastries. After putting aside enough money, she sought financing to purchase a car for a transport business. Banks rejected her because she had no legitimate income (most banks in Colombia require proof of regular paychecks to open an account). Emilce had the good fortune of meeting someone that owed her a favor from years earlier, and this man offered to vouch for her at the bank. She was able to secure a small loan and purchase a car.

Emilce used the car to transport seafood products from an airport cargo hangar to various locations around the city. After some time in this line of work, she decided to upgrade to a taxi and work independently. She informed her supplier that she would be stopping her work with him. After he received the last shipment from her, knowing that he no longer would utilize her services, he refused to pay the \$1,000 for the goods. Emilce sought the help of an

attorney, but this attorney happened to know the supplier's attorney and these attorneys agreed not to take the case to court. Emilce received nothing.

Emilce was eventually able to trade her car for a used taxi and now operates with a meter as an independent operator. She pays a monthly \$30 fee to a taxi cooperative to maintain her right to operate a taxi in Bogotá, but she pays nothing to the state. Emilce earns enough driving her taxi to pay for her children's education and provide food for the family. She has no interest in formalizing and sees the possibility of paying additional fees to operate her business as unreasonable.

Emilce is capitalizing on the limited resources and skills that she has at her disposal in order to provide enough income to care for her and her daughter. Despite two significant shocks to her business—her husband stealing her truck and the seafood vendor failing to pay for the last delivery—Emilce has been able to use the informal economy to sustain her survival. She has no aspirations of formalizing or of relying on the state for help, which so far has not come.

Interview with a Taxi Driver, Bogotá

Ernesto is a self-employed, young taxi driver operating in Bogotá. He is married and has a two-year old son with whom he lives in the far outskirts of town, where housing is more affordable. He recently upgraded to a new taxi after his previous vehicle became too expensive to maintain. I spoke with Ernesto about the process of moving from one taxi to another in the transportation marketplace.

I learned from Ernesto that taxi drivers working full days and varied shifts earn approximately two million pesos per month, equivalent to roughly \$1,000. A taxi driver is required to associate with the Ministry of Transportation, which regulates taxis. The cost to

purchase a space (cupo) in this business is approximately 30 million pesos, or about \$15,000, in addition to a monthly fee of roughly 300,000 pesos, or \$150. New entrants to the taxi market can purchase a car with the operating license for approximately 75 million, or about \$38,000. Taxis do not operate without this license. Ernesto also affiliated with two radio dispatch companies in order to provide him consistent clientele and to reduce the insecurity associated with picking-up passengers on the street. He pays fees to each of these companies.

The license provides only the ability to operate and collect fares as set by the city. Taxi drivers are free to set their own rates for individual trips and to operate on any route that they choose. They do not generally report their income or pay taxes thereon. They might be classified as semi-formal since they have a license to operate but nothing more.

In order to purchase the taxi, Ernesto was able to acquire a bank loan for approximately \$10,000. He pays 800,000 pesos per month to pay off this loan, leaving him with roughly \$450 per month to support his growing family and pay for gas and car maintenance. Ernesto's wife, a former cashier at a market, left work to care for their new child; however, she will need to return to work soon to support the family.

I met with Ernesto one year after my initial interview to find out whether his economic situation had improved. Since last we spoke, his wife was still unable to find work and thus was taking care of their son full-time. Ernesto was working seven days a week, averaging 14-hour days. He had affiliated with two dispatch companies to increase the potential for business. His income had not changed. Yet through all of this, Ernesto could not conceive of any value in working with the state to procure his survival.

Firm Objections to Formalization

The bus system in Bogotá, Colombia, although unreliable and often intimidating, is comprehensive and heavily relied upon by many Bogotanos for transportation. Taxis are expensive and driving is restricted due to limited parking, high gas prices, and a law known as *pico y placa*, which forces every private car and taxi to remain parked two days each week during peak transport hours or face a fine.

Bogotá has been struggling to improve its mass transit system for years. Bogotá Mayor Enrique Peñalosa proposed the development of a mass transit system known as Transmilenio in 1997, based upon a similar Brazilian system. The system involved dedicated lanes along major arteries in Bogotá, scheduled service routes, and a ticket-based system. The project was managed by the McKinsey & Company, which has actively supported formalization projects throughout Latin America. The routes opened in 2000 and ridership is currently over 1.6 million. The goal of Transmilenio was to eliminate the congestion caused by a disconnected private bus system throughout the city. As of 2010, no noticeable change in private bus service has been achieved.

In March 2010, Bogotá Mayor Moreno proposed integrating the private bus system into a smaller, more efficient process. 53 of the 66 bus companies would be eliminated and drivers would receive salaries rather than collecting fares from passengers. The current system encourages drivers to stop randomly and drive erratically to pick-up willing customers.

This plan to formalize and consolidate the bus system largely backfired when drivers felt that they would not receive close to the amount that they make in fare collection under the new salary-based system. My informal conversations with drivers indicated that they currently earn approximately 400,000 pesos monthly (\$1,000) and the salary would be $\frac{1}{4}$ of that amount.

Because drivers are heavily leveraged financially when they purchase a bus initially, they need sufficient income to pay down their debt and earn a livable wage.

Once the proposal was received by the Small Transport Association (la Asociación de Pequeños Transportadores), Apetrans, nearly all of the 16,000 bus drivers in the city declared a strike. Predictably, the city nearly shut down for the four days in which the buses did not run. *Pico y Placa* was lifted and taxis worked overtime to get people to and from their jobs. The handful of buses that skirted the strike in order to capitalize on the lack of competition were attacked and damaged by striking drivers.

The strike ended with an agreement between Apetrans and the city, but the specific details of that agreement have not yet been released. This effort at formalization and integration is one example of the risk a city faces when attempting to eliminate the principal profit-making mechanism for a firm, or group of firms.

Survey Data Indicators

According to the DANE in Colombia, 47% of independent workers would not take a formal job if offered, even at the same salary and including benefits. This percentage is significantly higher for informal firms, which indicate a 77% preference for staying informal even if offered a salaried position at the same rate of pay.

The principal reasons for individuals to start an informal firm are that they want to work independently (36%) or that they could not find another job (31%). Working independently offers numerous benefits, including freedom from taxation, flexible schedules, and no entry requirements. However, a key problem with informal work for the worker is the lack of access to a pension in old age.

Eva Hernandez, 75, sells newspapers in Bogotá. She has no formal education and is unable to read the papers that she sells. “Working informally means that you don’t have to have the help of a company behind you. I’d have liked a formal job, but this was the best I could do.”²⁴⁹ As she has never held a formal job, Ms. Hernandez has never contributed to the Colombian pension system, meaning that she will not be able to receive social security benefits from the state.

Recent DANE data indicates that only 16% of informal workers are affiliated with the pension system as of December 2008, compared to nearly 80% of formal workers. This equates to a country with 3.6 million workers that will never receive a pension out of an informal population of roughly 4.9 million workers in the 13 largest metropolitan areas of Colombia.

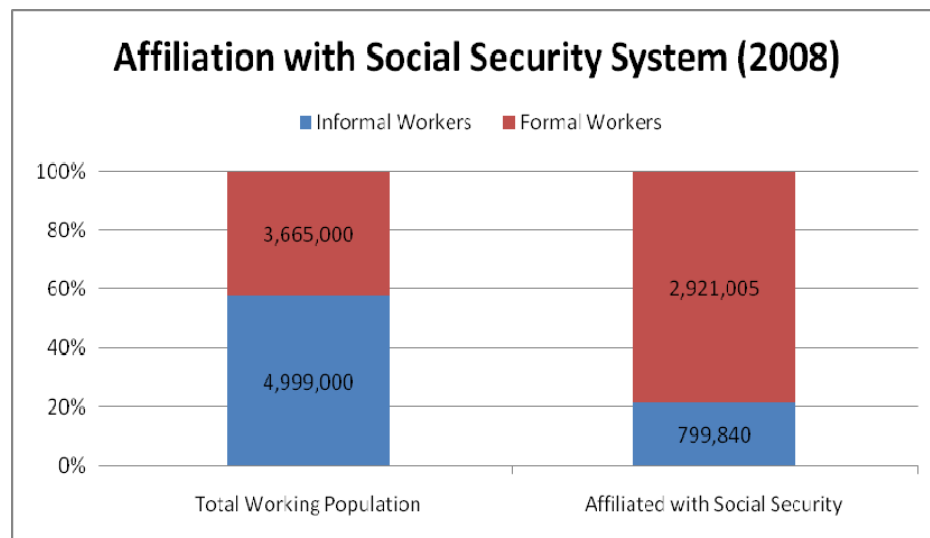


Figure 14. Informal and Formal Affiliation with the Colombian Pension Scheme.
Source: DANE, Principales Indicadores del Mercado Laboral (October – December 2008).

²⁴⁹. , *Waiting Game for Colombia’s Informal Workers*, British Broadcasting Company 2010.

Conclusion

Undoubtedly, change brings protest. State-led efforts to formalize small businesses will inevitably meet with objections as those changes threaten to remove the safety net of informality from so many that depend upon their illegitimacy to survive. The interviews and data in this chapter show that there is little taste for formalization, even if the state were able to offer the same salary and benefits, which it is unlikely they can do. These workers want the benefits that formalization promises, including pensions and stable income, but the economic and social costs are too high. An informal worker would have to be convinced that he or she will consistently earn the same amount they currently earn, taking into consideration the cost of registration, formal space, formal supplies, and taxes.

Yet even if the economic benefits are clear, lack of trust in the state may prevent any agreement to formalize. From my many interactions with informal workers, I found no such worker that believed in state promises to provide for them and protect their right to work. While many maintained the dream of operating a legitimate business, none felt confident that the state would help them achieve that goal.

Part III: Analysis of the Liberalization and Formalization Process

Introduction to Part III

The informal economy around the world is growing. Roughly 60% of workers worldwide are employed informally. According to the International Labor Organization, globalization is not making the situation any better as previously formal jobs are becoming less formal as firms attempt to cut costs to remain competitive.

The situation in Colombia is in many ways a microcosm of the global trend toward more informality in the face of globalization. The most recently available data there show that informality increased between 2007 and 2008, likely as a result of the reduced global demand for Colombian exports, which may have forced more Colombian firms to cut labor costs by relieving formal workers. Given the state of the economy in 2010, the trend toward increased informality appears likely to continue.

Although it may seem counterintuitive, full economic recovery in the face of continued trade liberalization is not likely to yield positive reductions in informality. As I have described in the previous chapters, small firms choose to operate informally because it gives them the freedom and flexibility to work on their own terms, and because it allows them to engage in gainful work due to the avoidance of taxes and fees that they otherwise would be subjected to as formal firms and workers. As liberalization pushes domestic firms in developing countries to seek ways to become more competitive to find their place on global markets, informality will

continue to serve as an outlet for workers that lose their formal jobs, need second jobs due to low wages, cannot find a formal job, or prefer working informally.

This section of my thesis reformulates the common argument that informality can be overcome with economic incentives and streamlining of the formalization process. And while I do not contend that CAEs and streamlining business procedures are harmful to the Colombian economy, I explain why these incentives will be insufficient to overcome the desirability of informality. My focus is on three significant objections to the incentives approach.

First, I argue that economic incentives fail to account for weak rule of law in Colombia, as well as in most developing countries today. Passing new laws and regulations and increasing enforcement mechanisms have less success in the face of citizens that lack trust in the state and state institutions. Because formalization requires a contract with the state, rule of law is likely the most significant barrier to formalization.

Second, I contend that a single formalization process is insufficient to address the multifaceted needs of the members of the informal economy. Some firms use the informal economy as a cheap and temporary mechanism to start their business, always intending to register once they see the way to profitability. Others default to informality because they have a useful business idea but no understanding of how to take it forward within the formal economic structure. And still others, likely the majority, prefer avoiding a relationship with the state either because they can benefit economically by doing so, or because they see no value in becoming formal. Approaching formalization with a unitary view of the informal economy will only capture a small segment of the target population.

Third, I debunk the idea that formalization leads to increased productivity by showing that the formalization process does not provide the tools necessary to add productivity to an

otherwise unproductive firm. I explain why this legal process is limited in its ability to overcome the substantial barriers to firm development and competitiveness faced in the informal marketplace. Given that the majority of these firms only survive based upon an avoidance of formality, formality, by its nature, is more likely to place the firm out of existence than to make it a productive contributor to society.

The conclusions and recommendations based upon the foregoing analysis and critique are found in section IV.

Chapter 9: Rule of Law and the Informal Economy

Introduction

Despite the extensive economic literature surrounding the discussion of the informal economy, the concept itself is largely a legal one. To be informal necessarily implies lack of compliance with certain laws and regulations—in essence, the unlawful operation of a business or unlawful employment. Yet the role that law and legal institutions play in the attempted remedies to growing informality has been limited and as a result, largely overlooked in formalization programs. In this chapter, I will explain why law and legal institutions are central to any effective program to reduce informality, and how a failure to address their role can significantly weaken the success of any formalization program.

Law pervades nearly every facet of informality. When regulatory barriers to business registration and taxation are perceived as the bases of informality, it is the law that establishes and modifies those systems. When property rights and registration are seen as a root cause of worsening informality, the law establishes relevant rights and registries. When contracts are drafted that lack enforcement authority, the judicial system serves as the body to mediate, interpret, and apply the law. And perhaps most importantly, when laws are ignored or circumvented, it is legal institutions that facilitate the prosecution of violators.

On a macro level, there is a culture of law-avoidance that permeates the informal economy. With little respect for laws on the books, and an awareness of weak law enforcement mechanisms to prevent them from continuing their violations, informal firms operate in spite of the law. This has made it exceedingly difficult for states to convince even law-abiding citizens that adherence to legal codes and submission to the state as the enforcement authority is beneficial to their interests. It also makes analysis of the impact of laws on the business environment, especially informality, exceedingly difficult as a law on the books has little association with a law enforced.

Rule of law refers to the contract between a society and the state in which the state agrees to protect the property and rights of society and society consents to be governed by and acquiesce some freedoms to the state. In recent literature, rule of law has come to refer to a culture that respects law regardless of the likelihood of being caught for violating it. "In most studies the rule of law appears to be measured in part by reference to the characteristics of the legal institutions and in part by reference to the extent of compliance with the law."²⁵⁰

Industrialized states have enjoyed great success in implementing a culture of rule of law. The vast majority of citizens in these economies have submitted to the state to such a degree that they naturally obey the laws, regardless of the reasonableness of those laws or the risk of being apprehended for violating such laws. This contract has been a veritable failure in most developing countries. A small group of elites and middle class have consented to a limited degree to be ruled by the state, but the vast majority of the population has not, either because they distrust the state or because they have no reason to seek state protection of their property.

250. MICHAEL J. TREBILCOCK & RONALD J. DANIELS, Rule of Law Reform and Development 10 (2008).

In this chapter, I will briefly trace the history of rule of law and how it maneuvered its way from the historical concept of a just sovereign to the modern day concept of a social contract. I will go on to connect the rule of law approach to informality and explain how informal economic activity is rational behavior unregulated by the state. Finally, I will look at the role of legal institutions, both formal and informal, in shaping the success of formalization projects.

The Development of Modern Rule of Law

The rule of law concept has its roots in ancient Greece. In Fifth Century B.C. Athens, Plato wrote the first major legal code, "The Laws", intending to restrain rulers from acting of their own accord and to provide a stable body of law from which magistrates could pass judgment on the population.²⁵¹ Plato's student, Aristotle, spoke of the rule of law as self-rule, subjugation of government officials to law, and law as part of reason:

[H]e who bids the law rule may be deemed to bid God and Reason alone rule, but he who bids man rule adds an element of the beast; for desire is a wild beast, and passion perverts the minds of rulers, even when they are the best of men. The law is reason unaffected by desire.²⁵²

These early scholars laid the foundation for the development of modern day rule of law, but it was not until 1215 that the concept of law as superior to the king was formalized. The issuance of the Magna Carta in that year, apparently an effort by nobles to reign in the King's

251. PLATO, *The Laws* 174 (Trevor Saunders trans.). See also BRIAN Z. TAMANAHA, *ON THE RULE OF LAW: HISTORY, POLITICS, THEORY* (2004).

252. ARISTOTLE, *POLITICS*, BOOK III 78 (STEPHEN EVERSON trans.).

growing power and the threat posed to their property, established the idea that a king is not a king if he does not rule well, and ruling well requires tempering your rule with law.

For his is called *rex* not from reigning but from ruling well, since he is a king as long as he rules well but a tyrant when he oppresses by violent domination the people entrusted to his care. Let him, therefore, temper his power by law, which is the bridle of power, that he may live according to the laws, for the law of mankind has decreed that his own laws bind the lawgiver, and elsewhere in the same source, it is a saying worthy of the majesty of a ruler that the prince acknowledge himself bound by the laws. Nothing is more fitting for a sovereign than to live by the laws, nor is there any greater sovereignty than to govern according to law, and he ought properly to yield to the law what the law has bestowed upon him, for the law makes him king.²⁵³

The idea that a ruler is bound by a set of laws significantly changed the dynamic of political development, placing more power in the hands of the lawmakers than in the sovereign. This concept was carried forth through the late seventeenth and early eighteenth centuries in the works of John Stuart Mill and John Locke, among others.²⁵⁴ Looking through the lens of liberty in this era, freedom became synonymous with rule of law. In a society where individuals consent to be bound by the law, order is preserved, conflict avoided, and equality promoted. A state that is restrained by law and a population that obeys the law creates the framework for a peaceful society.

It is worth noting that legal scholars do not generally link rule of law with democratic development. "The mere commitments to generality and autonomy in law and to the distinction among legislation, administration and adjudication have no inherent democratic significance."²⁵⁵ Rather, as legal scholar Brian Tamanaha argues, while rule of law is necessary

253. HARRY BRACON, ON THE LAWS AND CUSTOMS OF ENGLAND 305-06 § 3 (1968).

254. TAMANAH, 32-33.

255. JEAN JACQUES ROUSSEAU, Du Contrat Social, Principes du droit politique (Of the Social Contract, Principles of Political Right) (1762).

to maintain a democratic society, democracy is not required to establish the principles of rule of law.²⁵⁶

The liberal form of government that we often associate with rule of law today may be best embodied by the work of John Locke. In Locke's *Second Treatise of Government*, written in 1690, he refers to natural laws (the state of nature) that allow individuals to pursue their own life, health, liberty, and enjoyment of their possessions. These natural laws also provide the right to take action against anyone that infringes upon your rights. Realizing the inherent conflict that a state of natural law alone would create, Locke proposed that a government exist to resolve disputes by applying laws enacted by the people to protect their rights and property and stressing that this government should be relieved of its powers if it fails to act in the public interest.²⁵⁷

Interestingly, and quite relevant to economic development theory, Locke's principal motivation seems to reflect the original intentions of the Magna Carta—to protect private property. According to Locke, "[t]he great and chief end, therefore, of men's uniting into common-wealths, and putting themselves under government, is the preservation of their property."²⁵⁸ Locke associated reason with the property-holding elites and implied that they should be the rulers in a liberal state. Rather than seeing rule of law as a mechanism to promote equality and just access to property, Locke seems to have fortified the idea that a liberal society should consist of laws that preserve the elite's way of life through an established

256. TAMANAHA, 37.

257. See JOHN LOCKE, *The Second Treatise of Government* (1690).

258. *Id.*

body of law that punishes those who would threaten that way of life, namely by infringing upon property rights.²⁵⁹

Karl Marx took issue with Locke's approach to the rule of law. According to Marx, rule of law as articulated by Locke and other liberal scholars, simply established laws that promoted and protected the already elite individuals in a society, strengthening their position of power and perpetuating further inequality. According to his colleague, Friedrich Engels:

As the state arose from the need to keep class antagonisms in check, but also arose in the thick of the fight between the classes, it is normally the state of the most powerful, economically ruling class, which by its means becomes also the politically ruling class, and so acquires new means of holding down and exploiting the oppressed class.²⁶⁰

The free market associated with late nineteenth century England played a significant role in spurring popular protest against elitist rule and likely contributed to Marx and Engels' viewpoint. The industrial advances stemming from the development of the railroad made a substantial portion of the population wealthy, but left a mass of laborers without effective means to overcome their poverty. Labor protests in the 1870s and 1880s led governments to implement social programs to offset some of the negative externalities caused by the economic progress made in that period. This began the idea of a social welfare state.²⁶¹

In order to coordinate social programs, states created administrative agencies that were endowed with substantial powers and funding. These agencies were given the power to make discretionary decisions outside the purview of the courts or the law. Constitutional law scholar A.V. Dicey considered this to be a threat to the continued existence of the rule of law. In his

259. TAMANAHA, 50-51.

260. FRIEDRICH ENGELS, *The Origins of the Family, Private Property and the State* 156-57 (1942).

261. TAMANAHA, 62-63.

estimation, rule of law consisted of three elements: 1) no punishment unless a pre-existing law was violated; 2) everyone is equal before the law, including state officials; and 3) rule of law emanates from the totality of the judicial decisions in cases brought before the courts.²⁶² Because the administrative bodies doling out social welfare were doing so outside of the courts, Dicey and others argued that the belief in rule of law was waning.

Friedrich Hayek joined Dicey in his critique of administrative agencies as a threat to the rule of law. In his work, like Dicey, Hayek proposes three requirements for effective rule of law: 1) generality - law is set out in advance in abstract terms and not aimed at any particular group or individual; 2) equality - laws apply to everyone and make no arbitrary distinctions between people; and 3) certainty - those subject to the law are able to reliably predict the legal rules that will guide their conduct.²⁶³ Hayek contended that the increasingly common social welfare programs were aimed at particular groups and thus violated the idea of applying the law abstractly and generally.

It is in fact these very social welfare programs that have persisted in many developing countries today, maintaining the supply of basic goods and services to their poorest inhabitants. For the rule of law to be perceived as incompatible with a social welfare state because it places some discretionary authority within the state's hands, as Dicey and Hayek assert, is unfounded. Rule of law is not an abstract notion of the application of and adherence to the law of the state. This "thin" conception of the rule of law offers nothing more than a veil of legitimacy for state action that is otherwise unbounded. A state could pass into law mandates allowing slavery,

262. Id. 63-64.

263. Id. 65-66.

torture for criminals, and other unjust principles, yet they could still be said to be adhering to the rule of law.²⁶⁴

Rule of law requires not just legal formalism - that is, the basic instruments of rule by law advocated by Hayek and Dicey, although that formalism is necessary. Law also serves as a series of rules that are meant to guide the behavior of those being ruled. A rule is general, applied only prospectively, and open to any kind of content.²⁶⁵ When these rules are confined to a single institution - that is, the courts, individuals have a clear guide by which to measure their actions. That which is not prohibited by those rules is permissible. This formal legality is what helped to drive the capitalist and liberal states that developed in the eighteenth and nineteenth centuries.²⁶⁶

But these rules are not limited to functioning in a liberal state. A social welfare state is also subject to rules; however, as Tamanaha argues, it is for the society to decide where to apply formal rules and where to allow the state discretion in its actions.²⁶⁷ If social welfare will benefit from state discretion through administrative actions, for instance, and it would not be efficient to apply formal rules to those situations, rule of law can continue to thrive in such a state. Today, administrative agencies are generally bound by judicial review of their actions, further formalizing their discretionary powers.

Formal rule of law theories divide the progression of rule of law development into three stages. Rule by law is considered to be the "thinnest" variation of rule of law. Here, law is used by the state to promote the interests of the rulemakers. Individual rights and freedoms are

264. See, e.g., JOSEPH RAZ, *The Rule of Law and Its Virtue*, in *The Authority of Law* 212-13 (1979).

265. TAMANAHA, 97.

266. *Id.* 97-98.

267. *Id.*

paramount in this conception. Formal legality follows with the guiding principles asserted by Dicey and Hayek that law should be general, prospective, and predictable. This version of rule of law emphasizes the right to justice and equality before the law.

The "thickest" variation of rule of law combines democracy with legality, facilitating the popular development of the law that will be equally applied. Thinner conceptions do not address how the law will be created but only how it will be applied. Thick conceptions of rule of law place the power to make the rules in the hands of those consenting to be ruled. According to legal scholar Jurgen Habermas, "the modern legal order can draw its legitimacy only from the idea of self-determination: citizens should always be able to understand themselves also as authors of the law to which they are subject as addressees."²⁶⁸

In a recent survey of the literature discussing the connection between rule of law and development, Michael Trebilcock and Ronald Daniels prefer advocating a procedural approach to securing rule of law.²⁶⁹ This approach looks to benchmarks in legal education, courts, and judicial effectiveness, to determine how a state is performing. Following Sen's capabilities approach, this approach uses institutions as a means to achieve the rule of law end, and sees a functioning court system or a democracy only as useful as the institutions upon which they are founded.

Rule of Law and the Informal Economy

At the time of the Magna Carta in 1215, the sovereign ruler was the equivalent of what we consider the state today – the executive, legislature, and judiciary. When the nobles pushed

268. JURGEN HABERMAS, *Beyond Facts and Norms* (William Rehg trans.).

269. TREBILCOCK & DANIELS, *Rule of Law Reform and Development*.

to impose rule by law upon the sovereign, the effort was meant to reign in sovereign power over the property of the nobles. Thus the seedling of a state under law was planted.

The nobles chose to impose law on the sovereign in their own interest. They were intent on protecting their property from state acquisition. The remainder of the population had little role to play in the operation of the state as most of the regions where rule of law was developing were also operating as feudal states or colonies. Only during the industrial revolution did the propertied class expand significantly, increasing the demand for protection under the law. These new property holders consented to be governed by the state in exchange for the state's willingness to protect their newfound property by law. Rule of law began to expand in its scope of coverage.

In exchange for the state's protection of the property of the individual, that individual was obligated to follow certain rules of the state. These rules included paying taxes, registering their property where appropriate, using their property in accordance with the law, and respecting the rights of others and their property. Violating these rules would generally mean a loss of property or of freedom. Based upon their strong interest in securing their property, the propertied class was willing to consent to these rules.

With time, the propertied class was able to successfully defend its property rights through the state, and trust in the state developed. Laws and regulations were created to maintain the interests of the propertied classes, including trespass laws, theft laws, contract laws, and criminal laws, all of which favored the interests of the property owner. The rule of law contract between the state and the property owners was solidified with trust that the state would protect the property owners' interests. Rule of law, then, became a viable political function of the state that benefitted both the state and the propertied class.

John Locke famously explained that modern society developed out of a state of nature. That state of nature involved individuals protecting their own property interests and defending those interests as they saw fit against those who would infringe upon them. Of course, conflict would naturally ensue as disputes over property ownership or methods of protecting that property arose. According to Locke, the rationale for an individual to leave the state of nature is the opportunity for an individual to have his rights protected by a set of enforceable rules applied equally to the entire society. Rule of law meant to reign in the ability of anyone, including the state, to infringe upon anyone else's property interests. Individuals that owned property were willing to consent to be governed in exchange for this necessary property protection.

Between the issuance of the Magna Carta and the start of the industrial revolution, the propertied class in newly developing states was small. The number of individuals consenting to the state to protect them, then, was also small. This changed with the advent of industrialization. In the late eighteenth century, following the invention of the steam engine and the subsequent shift toward mechanized production, economic growth created opportunities for a much larger group of individuals to become property owners. This led to a great expansion of the propertied classes, first in modern-day developed countries, and later in most developing countries.

As the size of the propertied class expanded, the demand for property protection grew. With more people interested in protection from the state, more people consented to be ruled by the state. This fueled both a growing state and also a growing body of law by which the state could effectively protect the property of the vast propertied class.

However, not everyone joined the propertied class. Many manual laborers and unskilled workers found themselves out of work in the face of rapid industrialization. This spurred the critiques of Marx, Engels, and others who felt that the economic development approach of late eighteenth century states was strengthening the former feudal system and maintaining a discriminatory economic structure.²⁷⁰

As this process of industrial development and technological innovation continued, the propertied class continued to expand and the state continued to grow in strength. An industrialized society that adhered to the rule of law became synonymous with an advanced economy. In these advanced economies, the majority of the population enjoyed some level of property ownership. Intending to protect that property, the majority also consented to rule of law under the state. Indeed, rule of law was meant not only as a mechanism to protect property from unreasonable acquisition or use, but it also served as a tool to measure the level of societal development.

Rule of law can be segregated within, as well as between, states. What developed since the industrial revolution is a society that can be divided into three classes. The first, what Marx would call the bourgeois, are those individuals that own enough property to encourage them to consent to be governed by a state that will protect that property. These are the modern-day middle and elite classes. The second are those that own some property but that lack trust in the state to protect it, or that do not see the tradeoff between consent and protection as balanced

270. See TAMANAHA, 51. (arguing that Marx found the liberal state and law to function in favor of elite interests); see also JEFFREY E. NASH & JAMES M. CALONICO, MODERN SOCIETY: MEANING, FORMS, AND CHARACTER 128 (1992).(finding that Marx thought industrialization would exacerbate class divisions and conflict).

in their favor. This might be considered the propertied lower class. And finally, those without property that can be protected by the state fall into the lowest class, or the proletariat.

These three classes can be measured not only by their real and personal property assets, but also by their adherence to the rule of law. Societal elites have the most significant interest in seeking state protection of their property, whereas the less propertied classes have a declining interest in such protection. The elites also have the most power to enact laws in their favor to strengthen the protection of their rights. Consider the growing body of intellectual property laws and the push for stronger enforcement in developing countries, for instance. As substantial property owners, they have the social and economic resources to mount effective political campaigns and take leadership positions within law- and policy-making institutions. As Douglass North has consistently argued, when elites maintain control over lawmaking institutions, economic growth is limited to certain segments of society – namely those occupied by the elites.²⁷¹

The unpropertied and least propertied classes, despite their economic and social position, often remain active participants in the economy. In order to survive, they engage in activities outside the traditional economy using their limited skills and resources. We might think of this phenomenon as economic survival in a state of nature. With little recourse to the state for protection, and little desire to consent to state laws and regulations, these economic actors protect their rights through alternative means, outside the rule of law.

Locke's state of nature, then, has largely dissipated in advanced economies as vast populations of property owners yield some of their individual rights to the state. In developing

271. DOUGLASS C. NORTH, *Institutions and Economic Growth: An Historical Introduction*, 17 World Development, 1320 (1989).

countries, however, this state of nature persists among the least enfranchised. Fewer elites and a small middle class in most developing countries lessen the pool of adherents to the rule of law, perpetuating a culture of lawlessness. Yet rather than brute conflict and demand for state intervention, the inhabitants of the modern day state of nature use informal dispute resolution mechanisms and respect for the rights of their cohabitants to create a livable environment.

These economic actors in the state of nature are resourceful, aggressive, and often entrepreneurial in their attempt to earn a living. They occupy jobs that drive the economy, such as maid and janitorial services, construction, primary good extraction, transportation, tourism, and entertainment. They alleviate some of the burden on the state by providing necessary services, such as transport and trash removal, and by generating enough income to maintain a minimal standard of living without complete dependence upon state social services. Yet they also detract from the growth of the modern economy by undercutting formal businesses and dissuading intending investors that might prefer a more fair and regulated marketplace. Thus the dilemma of the informal economy.

In Keith Hart's seminal study of the Ghanaian economy in 1972, he explained that the formal economy is defined by the regularity of its order and predictability.²⁷² There is a greater ability to plan, invest, and take risks when income is regular and adequate. This regularity and form is intended to be the manner in which broader society is organized. The state, in Hart's estimation, arose to play the role of giving citizens access to what was rightfully theirs. This led to state protection of rational enterprise, which it likely perceived as most in line with modern industrial development. "National bureaucracy lent these [rational] firms a measure of

272. HART, *Bureaucratic Form and the Informal Economy* 21.

protection from competition, thereby allowing the systematic accumulation of capital.”²⁷³

Irrational, or informal firms, were not afforded such protections.

Hart implies in his work that the state has failed to provide equal access to rights that it was created to protect.²⁷⁴ Yet it appears from a historical perspective that the rationale behind the creation of the state bureaucracy was to reign in authoritarian power and to protect individual assets. It was not intended to provide broader access to existing resources through redistribution of property. The state, it seems, was meant to protect the existing system rather than to promote a more just system.

How Does Law Hurt Informal Activity

Modern legal codes have developed in line with the basic tenet that private property should be protected. In the context of informal firms, certain areas of law are particularly harmful to the prospect of linking the informal and formal sectors. The following are a selection of examples from some more common areas of law.

273. Id. 24.

274. Id. 22.

Contracts

Contract enforcement often stands out in economic analysis as one of the rationales for formalization. However, there is nothing inherent in the law that discriminates between formal and informal contracting. Rather, it tends to be the nature of the property being exchanged or service being provided by the informal firm that creates a problem for legal enforcement.

Basic contract principles posit that the state will step in to protect the rights of the parties when those parties have entered into a legitimate contract and one or both have failed to comply with their obligations under that contract. Contract law tends to favor written contracts, but many legal systems also permit oral contracts to be enforced with adequate evidence of an agreement. A valid contract also generally requires a legitimate purpose. A valid contract cannot be made to sell stolen merchandise or to take action that would be in violation of the law.

Written contracts are practically non-existent in the informal economy. Agreements between vendors and their suppliers are negotiated and concluded orally; agreements between domestic workers and their clients rarely involve a written agreement; and purchases from street vendors would never result in a receipt confirming the purchase. As such, informal firms rely on oral contracts to facilitate business and keep few records that could evidence their agreements in court. Additionally, even if they could provide adequate evidence of these agreements, they would face difficulties enforcing contracts for goods or services provided contrary to law, such as the sale of illegitimately obtained goods, work in violation of labor laws, and business transactions made without a legitimate business license or payment of taxes.

Contract law sets forth standards to differentiate valid from invalid contracts. Valid contracts tend to be those that are more commonly concluded by property owners who have the ability to draft written contracts, seek legal counsel, pay legal costs to enforce contracts, and justify their claims by proving the legitimacy of their goods or services. It does not protect many of the activities in the informal economy. Accordingly, contract enforcement via the courts becomes difficult for informal firms as they cannot prove the legitimacy of what they sell or their compliance with the law in the provision of their services.

Property Laws

Property laws include a range of protections, such as titling and registration, intangible protections (such as intellectual property), and rights against theft and trespass. While there are some variations in the law, most property laws protect the registered owner of a piece of land, structure, or good. Ownership of real property is determined by formal deed or, failing that, a showing of successive passing of title. Ownership of personal property is determined by possession and legal title in the form of a receipt of purchase, registration, or other evidence.

A great deal has been written about the role of property in the informal economy.²⁷⁵ Squatting on real property and acquiring personal property through illegitimate means (theft or unlawful exchange) place a significant burden of proving ownership on the informal firm. With little to show for title, possession serves as the primary means of proving ownership. To maintain ownership, then, requires remaining with the real property for long periods, and carefully guarding personal property. In most cases, a challenge by the rightful owner of property taken improperly by an informal firm will succeed or will be met with violence.

275. See, e.g., HERNANDO DE SOTO, *The Mystery of Capital* (Basic Books. 2000).

As discussed at the outset of this chapter, property protection serves as the principal rationale for establishing a rule of law system. Property laws govern the state's ability to take property away from individuals, and they also establish ownership rights in an individual such that they can transfer those rights freely. In many ways, these laws form the legal basis for long-distance trade, innovation, and general commerce. As informal firms tend to operate out of their homes or on public space, property laws create a number of legal problems for these firms, such as establishing an address to seek state benefits or apply for credit, protect against competing claims for space, and maintain a safe working environment.

Intellectual Property

Most states have laws that outlaw the sale of goods that infringe upon the rights of the lawful owner. The rationale behind such laws is that the owner of the original good or idea has a legitimate interest in controlling the distribution of his goods and preventing sales of these goods without receipt of royalties. These laws are often enforced with seizures of the goods and associated fines.

In many developing countries, infringing goods are sold at a substantially lower price than the retail price for legitimate goods, and informal vendors earn their living on the small markup that they add to the goods. Commonly, these goods include books, music, movies, and electronics. In most developing countries, all of these goods can be purchased from street vendors, small stores, and in informal markets.

Intellectual property laws in general and infringement laws in particular target the unlawful sale of legitimate goods. The efforts of the state to promote fair competition and to encourage innovation and foreign investment have led them to locate trade within the formal

marketplaces and attempt to prevent unregulated exchanges from taking place. In their effort to convert the bazaar into the shopping mall, intellectual property laws can undercut a substantial marketplace that generates a livelihood for a number of small firms.

Perception of Weak Institutions

Lack of confidence in a state's established legal institutions can perpetuate a culture of weak rule of law. Avoidance of laws perceived as benefitting the rich at the expense of the poor, for instance, is common in Latin America. "This failure...may intensify the tendency of many Latin Americans...to opt out [of compliance], rendering the fulfillment of the fundamental roles of the state all the more difficult."²⁷⁶

Rule of law reform efforts tend to take this phenomenon for granted. Such programs promote streamlining laws, strengthening enforcement, and expanding access to justice. Yet there is surprisingly little recognition for the fact that these laws are all but ignored by large swathes of the population. The accepted approach for law reform beginning in the 1960s in developing countries was to expand the role of the state in developing markets, increasing productivity, and regulating the private sector.²⁷⁷ Trubek and Galanter describe the rule of law model as follows:

The [Rule of Law] model assumes that state institutions are the primary locus of social control, while in much of the Third World the group of tribe, clan, and local community is far stronger than that of the nation-state. The model assumes that rules both reflect the interests of the vast majority of citizens and are normally internalized by them, while in many developing countries rules are

276. PERRY, et al., 12.

277. DAVID M. TRUBEK, The "Rule of Law" in Development Assistance: Past, Present, and Future 75 (David M. Trubek & Alvaro Santos eds., 2006).

imposed on the many by the few and are frequently honoured more in the breach than in the observance. The model assumes that courts are central actors in social control, and that they are relatively autonomous from political, tribal, religious, or class interests. Yet in many nations courts are neither very independent nor very important.²⁷⁸

A large informal economy breeds greater acceptance of violations of the law to operate informally. “The more intensive the contact is with like-minded individuals, the easier it is to justify personal willingness to engage in shadow economic activities.”²⁷⁹ Maloney goes so far as to contend that noncompliance with established laws may undermine the legitimacy of state institutions and erode the rule of law altogether.²⁸⁰ He argues that, “[n]oncompliance [with the law] may become a social norm that increases the costs of enforcing the law, undermines the legitimacy of societal institutions, and creates horizontal and vertical inequities (with better-off insiders and worse-off outsiders).”²⁸¹

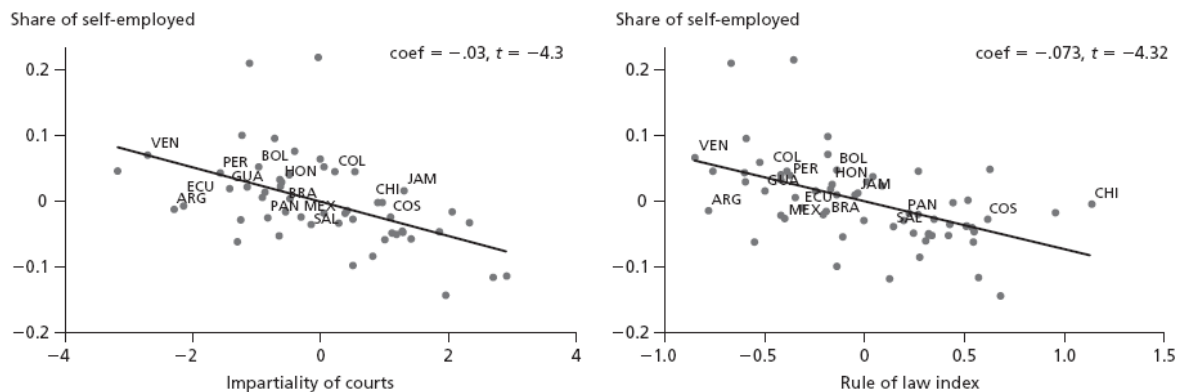


Figure 15. Correlation between weak rule of law and informality.²⁸²

Source: World Bank (2007).

278. DAVID TRUBEK & MARC GALANTER, *Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development Studies in the United States*, 4 Wisconsin Law Review 1062, 1080-81 (1974).

279. SCHNEIDER & ERNSTE, *The Shadow Economy: An International Survey* 83.

280. PERRY, et al., 22.

281. Id.

282. Id. 221.

But the fact that an informal economy conducts business outside of the law and fails to adhere to state requirements that they perceive as unrealistic, may result from weak rule of law rather than contributing to it. For instance, if a small firm intends to begin operating in a state that requires basic registration procedures and payment of annual registration fees, that firm will have to consider the basic rule of law tradeoff question – is relinquishment of certain rights to the state justified in light of what the state will do for the firm? In the case of a firm with limited resources and little trust in the state, the tradeoff may tip in favor of informality not because of a desire to avoid the law, but because of recognition that the social contract is an unfair bargain for the firm.

In reality, a vicious cycle exists in which firms reject the social contract with the state because the firms see the bargain as objectively unfair; they would be giving up much more than they would be getting. They choose to operate their firm informally in the face of weak law enforcement mechanisms, and their view of the state as an unfair bargainer hardens. As this informal economy expands, more firms become aware of this unfair bargain and breach (or never conclude) their contract with the state. Rule of law weakens as the state loses its legitimacy to provide protection for formal firms against those operating in the state of nature.

“In the long run...a society cannot accept offences against laws and rules, as the latter form the basis of the state. The ‘common good’ is threatened by the increase of the shadow economy that, in turn, results from the withdrawal of politics from the desires and wishes of the public.”²⁸³ Schneider and Ernste are echoing the worry that as the informal economy grows in

283. SCHNEIDER & ERNSTE, *The Shadow Economy: An International Survey* 192.

size, the state becomes less able to provide for the propertied class' protection, which may eventually lead to a complete rebellion against the state.

What we can conclude from this discussion is that the basis for the informal economy's rejection of the state may have more to do with the institutions in place to protect the rights of the less-propertied classes than with the state's overly bureaucratic firm registration processes. "[O]vercoming the culture of informality probably requires major improvements in the quality and fairness of state institutions and policies."²⁸⁴ As evidence of this suggestion, informal firms generally avoid formal legal institutions for the resolution of disputes. However, they have developed their own equivalent institutions to serve their needs where the state cannot.

Informal Legal Institutions

Legal institutions are the practical support system for the rule of law dynamic. They are the visible elements of a society's embodiment of legal rules and processes. They include formal courts, mediators, administrative tribunals, judges, juries, magistrates, police, prisons, and of course the law itself. These are the rule of law devices that members of society interact with on a regular basis.

Institutions are valuable for a society because they reduce transaction costs and provide trust and security. Like rule of law in particular, institutions generally provide a level of predictability that generates confidence in firm and individual actions. Nobel laureate Douglass North commented that institutions are, "the rules of the game [in a society or] the humanly

284. PERRY, et al., 14.

devised constraints that shape human interaction.”²⁸⁵ Legal institutions fit neatly into this definition as they work to constrain behavior and guide transactions between individuals and between firms.

However, as I have argued elsewhere,²⁸⁶ formal legal institutions, such as courts, magistrates and police enforcement, are not always available, nor desired. In many developing countries, inhabitants are either excluded from accessing formal legal mechanisms due to the business that they are in (as discussed above), they find access too expensive or lengthy, or they do not trust the formal system to effectively resolve their dispute. In these instances, disputing parties resort to informal mechanisms.

These informal dispute resolution mechanisms are rational developments, and perhaps precursors to modern formal legal institutions. North and other institutional economists accept these informal mechanisms as essential to a functioning society. What he calls codes of conduct or cultural norms work hand in hand with formal legal mechanisms to promote efficient dispute resolution.²⁸⁷ When there is no effective contract between an individual and the state, these informal mechanisms may be the only reasonable option to protect their rights.

In fact, in some instances, formal legal mechanisms are used only to facilitate informal dispute resolution. A street vendor selling fruit on a public sidewalk that is injured by a reckless driver is unlikely to find much success in a lengthy and expensive court process. However, the police officer that arrives to investigate the accident may encourage the parties to settle their dispute informally and avoid the hassle of filing a report and proceeding through a lengthy and expensive judicial process. In developed countries, this process is quite similar to the out of

285. NORTH, *Economic Performance Through Time*.

286. FANDL, *The Role of Informal Legal Institutions in Economic Development*

287. NORTH, *Economic Performance Through Time*, 7.

court settlement process during litigation in which the judge will encourage the parties to save time and money by reaching an agreement before going on with litigation.

According to de Soto, “An informal legal system is a set of rules and guidelines by which individuals respect and enforce the rights and responsibilities of other individuals in situations that do not give rise to formal legal protection.”²⁸⁸ These mechanisms are especially useful in the areas of tort law and basic contract dispute resolution.

Informal law might be thought of as similar to traditional or mercantilist law, which developed early in the history of commerce and set the foundations for modern legal structures. Exchange was based on trust and reputation and disputes were settled within the confines of the community. As societies became more complex, more extensive legal structures evolved from these traditional mechanisms, including administrative law, codes, and hierarchies of legal authority. “Formal codified law emerges when the social structure of a given society becomes so complex that regulatory mechanisms and methods of dispute settlement no longer can be dependent on informal customs and social, religious, or moral sanctions”²⁸⁹ Yet in many developing countries, factors such as the lack of central political control, unified communities, and weak economic development, have prevented them from fostering a formal legal system.²⁹⁰

The fact that formal dispute resolution processes in many developing countries are lengthy and expensive further reflects the dynamic relationship between the three segments of society and the state. Those with valuable property can count on the fact that they have easier access to the formal courts, mechanisms to promote swift justice, such as familiarity with judges

288. SOTO, *The Other Path: The Economic Answer to Terrorism* 19.

289. STEVEN VAGO, *LAW AND SOCIETY* 39 (8th ed. 2006).

290. See FRANCIS FUKUYAMA, *Address at the IMF Conference on Second Generation Reforms: Social Capital and Civil Society* (1999). (“The fact of the matter is that coordination based on informal norms remains an important part of modern economies, and arguably becomes more important as the nature of economic activity becomes more complex and technologically sophisticated.”).

and access to good legal counsel, and the resources to await lengthy decisions without fear of going bankrupt in the process. Those with less or no property enjoy none of these things and have little trust in a fair or equitable resolution in the formal court system.

Operating without legal cover can be a distressing thought for firms in developed countries as they expose their transactions to significant risk. They mitigate this risk by participating in a formal legal system. Yet in the informal economy, informal legal mechanisms may be the only method of protecting business transactions. “[I]nformal institutions cannot be ruled out ex ante as suboptimal, given the type of enterprises operating within them and the level of development of the state.”²⁹¹ They may in fact be a viable substitute for formal legal institutions in some cases.

It is the quest for new solutions to complex societal problems that stimulates societal development.²⁹² This leads to North’s conclusion that a key aspect to good development policy is flexible institutional structures that adapt to their particular environment. Informal legal institutions that allow negotiation by community councils, punishment through expulsion from a community, and rules of conduct that facilitate equality between property-less individuals, may provide the flexibility that a society needs to function in a system in which a large portion of the population rejects the state contract.

Yet while informal parties might rely on informal legal institutions to protect their rights in limited circumstances, such as resolving basic tort and contract claims, these mechanisms are largely ineffective for larger shocks, such as criminal acts, violations of basic freedoms, or financial hardships. Perry and Maloney argue that, “[t]he presence of a large fraction of the

291. PERRY, et al., 25.

292. NORTH, *Economic Performance Through Time*, 364.

workforce in Latin America that does not count on formal mechanisms to hedge or mitigate these shocks is, hence, of intrinsic concern.”²⁹³ It is in these instances that the most serious concern exists for failed formal legal institutions. And it is in these types of disputes that the value of informal legal mechanisms diminishes.

Formalizing with the Rule of Law

Economic justifications alone cannot form the entire basis of formalization efforts if they are to be successful. In any analysis of the informal economy, it is essential to consider the behavior of firms and their interaction with the state. Many economists have recognized the importance of looking beyond economic motivating factors in order to “explain social processes and institutional change by applying theories that are based upon individual behaviour.”²⁹⁴ Yet formalization advocates maintain the preeminence of economic factors as the driving force behind the growth in the informal economy.²⁹⁵

Rule of law as an institution plays a central role in economic development. As discussed above, effective legal norms and adherence to those norms can facilitate business contracts, foreign investment, and trade. Legal institutions in Latin America are generally considered to be weak. The World Bank, in fact, indicates that Latin America is the region with the lowest number of firms that consider the government to be effective (30 percent), and is second only

293. PERRY, et al., 22.

294. SCHNEIDER & ERNSTE, *The Shadow Economy: An International Survey* 55.

295. See, e.g., *Id.* 105. (emphasizing the preeminence of economic factors in uncovering the root causes of informality).

to South Asia in its negative perception of a court's willingness to enforce contract and property rights.²⁹⁶

Yet these indicators focus on trust in the ability of formal judicial mechanisms to resolve disputes effectively and fairly. They do not address the demand for those institutions or the legal relationship between an informal firm and the state.

Several World Bank country analyses resulted in findings that there was little demand for formalization even once firms became aware of the potential benefits of operating formally. In Brazil, Mexico, and the Dominican Republic, formalization incentives such as reducing registration costs, were found to have little or no effect on the number of firms that would choose to formalize. Achieving effective formalization, according to Maloney, would require "positive incentives for joining the formal sector, including improvements in private and public services available to formal firms...and enhancing the level of enforcement to increase the opportunity cost of remaining informal."²⁹⁷

Law is thought to play two roles in formalization efforts. First, it serves as the basis for the argument that the informal economy lacks access to legal institutions, such as contract enforcement and property rights. And second, it is used as a justification for increased enforcement efforts that penalize informal firms for operating outside the law and penalizing formal firms for taking advantage of informal labor. Neither of these rationales effectively captures the contours of how the rule of law relates to informality.

This approach fails to capture the role that law plays in the informal economy. First, it focuses legal reform efforts on expanding the supply of law – that is, increasing opportunities to

296. PERRY, et al., 220.

297. Id.

access the formal legal system. What is lacking in this approach is an understanding of the demand for law. Second, the current formalization approach focuses on law as an enforcement tool. The McKinsey Institute, for instance, argues that stricter enforcement of the law is essential to promote productivity facilitate business by allowing the government to lower its overall tax rate.²⁹⁸ In the context of rule of law reform, increased enforcement refers to an expanded police force, increased resources for administrative agencies involved in enforcement (such as the tax administration), an improved system of prosecution, and funding for more (and better) jails.

However, increased enforcement of the law, aside from being an avenue to extract more rents from informal firms, is more likely to overcrowd jails and overwhelm courts than it is to have any impact on the size of the informal economy. “Simply tightening the enforcement of existing laws, particularly in the largely informal microfirm sector, may just eliminate jobs – many of which...[are] of good quality when measured by the worker’s overall welfare.”²⁹⁹ The need for productive income remains in spite of the level of state law enforcement.

Conclusion

Rule of law is at the heart of the social contract between a state and its citizens. It is an agreement by the state to protect the property and related interests of its citizens in exchange for the relinquishment of some individual freedom of the individuals to act of their own accord.

298. DIANA FARRELL, THE PRODUCTIVITY IMPERATIVE: WEALTH AND POVERTY IN THE GLOBAL ECONOMY (2006). FARRELL, THE PRODUCTIVITY IMPERATIVE: WEALTH AND POVERTY IN THE GLOBAL ECONOMY. at 100.

299. PERRY, et al., 15.

It is a contract that has yielded significant benefits in most developed countries where the majority of the population has an interest in property protection and has willingly ceded many freedoms to the state.

In developing countries, by contrast, compliance with legal rules has been less frequent, largely because the social contract has been unsuccessful. The majority of citizens in developing countries have little property to protect, and those that do maintain property see the relinquishment of freedoms to the state to be an unfair bargain. The result is a large and growing informal economy functioning outside the formal framework of the state.

The promotion of property rights and contract enforcement as primary benefits of formalization is misplaced. These goals, while valuable tools to improve rule of law generally, serve only to strengthen the existing supply of rule of law mechanisms and not to create new pathways to compliance with the law. There is no direct relationship between improved property rights and formal contract enforcement and a smaller informal economy.

Additionally, existing informal legal institutions play an important, but often overlooked role in a developing country. According to Basudeb Guha-Khasnobis of the United Nations University, for instance, "...the general advice is: Try not to replace or 'crowd out' informal rules that are generally understood and may potentially be relatively effective, but help to fine-tune them instead."³⁰⁰ Developing bridges between existing informal systems and formal systems of justice may prove to be far more effective than attempting to supersede already functioning mechanisms.

Whether the state is willing to accept a bifurcated legal system in which formal justice mechanisms exist alongside informal ones is a decision largely driven by the perception of the

300. GUHA-KHASNOBIS, et al., 13.

informal economy. “[W]hat is at stake here is whether society is just one thing – one state with its rule of law – or can tolerate a measure of legal pluralism, leaving some institutions to their own devices.”³⁰¹ If the informal economy is perceived as a drain on productive resources, a scar on the public space of developing country cities, and a deterrent to foreign investment, the state is likely to ignore informal justice mechanisms and favor encouraging informal firms and workers to seek formal dispute resolution and business operation.

However, forcing compliance with the law for the sake of creating a broader formal economy is a misguided approach. A firm’s willingness to comply with the law to avoid paying fines does little to change the culture of informality or weak rule of law. At the same time, a firm’s disinterest in complying with state laws says little about the viability of the laws as written. “[L]evels of compliance with the law in any given society need not be connected to characteristics of the society’s legal system.”³⁰²

What needs to be addressed in the discussion of law and the informal economy is the underlying rationale for an informal firm to comply with formal legal norms. If the social contract is perceived as tilted in favor of the state and the informal firm is unable to see any reasonable benefits in adhering to the rule of law, there is little hope of convincing these firms to formalize. Instead, states should be considering the possibility of a two-track justice system by which informal and formal dispute resolution processes exist side by side, and incentives should be developed to balance the social contract in order to attract more informal firms into the formal economy and the formal legal framework. These solutions will be discussed in the final chapter.

301. HART, *Bureaucratic Form and the Informal Economy* 31.

302. TREBILCOCK & DANIELS, *Rule of Law Reform and Development* 10.

Chapter 10: The Single Formalization Framework

Introduction

In most developed states today, sole proprietorships, small businesses, and large firms operate together and form a dynamic and productive economy. Individuals either work for these firms or manage their own firm, in both cases enjoying a great deal of protection and oversight from the state. The state provides a range of benefits, including social security, unemployment insurance, and subsidized education for workers, access to credit and business promotion services for firms, and reasonable enforcement of labor, tax and business laws to protect workers, firms, and the state. In this environment, high levels of respect for the rule of law lead the vast majority of individuals and firms to comply with most of their legal obligations, including registering their business, paying taxes, and adhering to labor, health and safety, and business laws.

This is not the case in most developing states today. Indeed a dynamic economy flourishes much like in developed states, yet this economy lacks the strong foundation of rule of law and is instead penetrated by a culture of distrust of the state. The modern developing state is a regulatory state struggling to control a diverse and growing economy with limited resources. Individuals and firms operate much like they do in developed states, yet many do so without adhering to or enjoying the benefits of the state. A majority of the work done in most Latin American economies is done outside the legal framework imposed by the state. This informal

economy serves as both a cushion for those that lose or are unable to obtain jobs in the formal economy, and also as an outlet for productive work that would be stifled if conducted formally.

There is no single solution to the problem of rising informality because there has been little agreement on what the root cause of its growth is. Many of the theories that have been proffered to reduce the growth of the informal economy tend to encourage law and policy reforms focused on business deregulation and reduction in taxation, small business promotion, and social protections for workers. This “incentives” approach suggests that with the right motivations, an informal worker or firm will choose to enter the formal economy and fewer firms and workers will resort to informality.

The incentive-based approach has been broadly adopted by states and development institutions alike, and has formed the basis of most formalization projects. This approach relies on the assumption that sufficient demand exists for formal institutions. However, as I explained earlier, informal firms appear to reject state control not because it is inadequately supplied or difficult to access, but rather because it is undesirable to have.

The Changing Landscape of the Informal Economy

Renewed attention has been focused on the informal economy in development circles. The growth of informal activities has alarmed many states and led to a rush to examine the potential impact of an increasing informal economy on economic development. Theories adopted by some economists and development institutions indicate that successful capitalist development will require a reduction in the size and scope of the informal activity. This assertion has formed the basis for a growing number of formalization projects throughout Latin

America. Before fully understanding the reason that formalization policies today are unlikely to facilitate a reduction in the size of the informal economy, I will explain how a single formalization approach developed.

After its initial stages of “discovery,” efforts to reduce the size of the informal economy were made under the guise of modernization theory. Under this approach, the informal economy was seen as a relic of underdevelopment and weak state control. Informality was characterized as the traditional economy that should dissipate with the advent of capitalist development and more effective state apparatuses. “For proponents of modernization, eradication of the informal sector was just a matter of time”.³⁰³ Modernization proponents believed that “traditional” economic activities would self-formalize to take advantage of capitalist markets; however, the opposite has occurred.

As capitalist development expanded and global competition became more intense, informal firms and workers grew in number to supply the market with competitiveness through cheap labor and services, and through their avoidance of payments to the state.³⁰⁴ In contrast to the proponents of modernization theory, such as Tokman,³⁰⁵ the informal economy expanded with the rise of capitalism rather than receding. “[L]arge-scale capitalism has prospered in opposition to and on the backs of the lower levels of the market and everyday life, both of which are home to informal economic activities.”³⁰⁶ This led to a renewed focus on the root causes of informality and how to contain its growth.

303. FARUK TABAK & MICHAELINE A. CRICLOW, *Informalization: Process and Structure 3* (Johns Hopkins University Press. 2000).

304. *Id.* 6-8.

305. TOKMAN, *Modernizing the Informal Sector*.

306. DAVE BROAD, *Periodic Casualization of Work 29* (Faruk Tabak and Michaeline A. Crichlow ed., Johns Hopkins Press 2000).

The new approach became to formalize rather than to modernize the informal economy. Informality was characterized as harmful to economic development, especially with respect to the expansion of business opportunities. “To develop a favourable business environment and adequate public services, a certain formalization of the economy is needed.”³⁰⁷ Formalization projects used incentive- and enforcement-based plans to stimulate growth of the formal economy and to reduce the frequency of informality.

This transition to formalization policy was never fully examined for its logic. “[G]iven the inequality embedded in the global division of labor that perpetuates regions as beneficiaries or nonbeneficiaries of the fruits of capital accumulation, formality cannot be seen as a conscious and clear goal of all states (or even capital) at all times, particularly during moments of economic and social upheaval.”³⁰⁸ For many firms, informality is a way of doing business that provides necessary competitive advantages without which the firm would likely fail. For the minority of firms, informality is a step in the process of eventual formal firm development that will come when the firm decides that it is ready to expand.

Today, four principal approaches are used to promote a reduction in the growth of the informal economy: 1) deregulation of business registration and reporting requirements; 2) modernization and streamlining of labor codes and business laws to promote freedom and flexibility in the workplace; 3) reform or revision of the tax code, and; 4) microenterprise promotion through business facilitation and access programs. I will explore these four approaches below.

307. Informal Employment Re-loaded. (2008).

308. MICHAELINE A. CRICLOW, Conclusion: Under the Shadows of Capital 182 (Faruk Tabak and Michaeline A. Crichlow ed., Johns Hopkins Press 2000).

The Deregulatory Approach

According to Hernando de Soto, the informal economy began as groups of street vendors searching for income in a market that failed to provide jobs and a hospitable business environment.³⁰⁹ Building on Hart's analysis, de Soto began to conduct research through discussions, surveys, and even undercover operations, within the informal economy in Peru. He and his team quickly learned that not only was Hart correct in his realization of the significance of this extralegal sector, but that this sector may be a primary driver of economic activity in the developing world.

Through experiential research, de Soto determined that informal workers and firms were not informal by choice, in most instances, but rather that they were being excluded from the formal sector by high barriers to entry. Rather than the lack of jobs available in the formal sector, de Soto surmised that it was the firm's inability to register their economic activity with the state in an affordable and efficient manner that prevented their entry into the formal economy.

Accordingly, for de Soto, the key to reducing the size of the informal economy lay in the state's regulatory structure. Burdensome, expensive, and complicated registration and licensing requirements, for instance, prevented otherwise productive workers from joining the formal economy. De Soto outlined the significant tradeoff of working informally, including the bribes, lack of security, instability, and weak legal rights inherent in informal economy business operations. In de Soto's estimation, it would be unreasonable to assume that someone would

309. Soto, *The Other Path: The Economic Answer to Terrorism* 59.

choose to work in the informal economy. Rather, they are forced there by the regulatory burdens imposed by the state.

Thus, de Soto recommended focusing reform on deregulation, making it easier and more affordable for informal firms to become formal firms. “The ideal solution would be to remove the obstacles and convert political incentives into legal facilities in order to free and increase the vendors’ entrepreneurial energies and to allow them, within the competitive proves in which they are immersed, to use their talents to the full and serve the community more effectively.”³¹⁰ Streamlining the regulatory process, making it accessible to the public, and encouraging businesses to register and reap the benefits of formal operation were de Soto’s solutions to the problem of informality.

The Doing Business Group at the World Bank largely adopted de Soto’s approach and today promotes efforts to stimulate economic development by reducing the costs of compliance with business and labor laws.³¹¹ Their annual report identifies countries considered to be good and bad performers based upon their ease of doing business ratings, including the ability to hire and fire workers, the number of steps required to register a formal business, and the costs of compliance with the law.³¹² These reports serve as Scarlett Letters on countries with high regulation, deterring investors from their shores.

Norman Loayza of the World Bank also follows the approach of de Soto and outlined the evidence supporting this perspective in his World Bank research paper, “The Economics of the Informal Sector”.³¹³ He starts out with the commonly held assumption that “[t]he informal

310. Id. 92.

311. See PERRY, et al., 44.

312. See, e.g., BANK, *Doing Business*.

313. LOAYZA, *The Economics of the Informal Sector: A Simple Model and some Empirical Evidence from Latin America*.

sector arises when excessive taxes and regulations are imposed by government [sic] that lack the capability to enforce compliance.”³¹⁴ He goes on to say that these excessive regulations may be created to benefit certain interest groups rather than society as a whole and that this fails to promote an efficient market economy.³¹⁵

The Structural Change Approach

Although one of the most common, the deregulatory approach is not the only avenue for reducing the growth of the informal economy. The structural school of thought suggests that the focus should be upon the relationship between informality and the broader economy. “[T]he existence of an informal market represents a vast subsidy to formal capitalist enterprises, insofar as it makes labor costs lower than they would be if such sources of supply did not exist.”³¹⁶ Formal firms depend on the informal labor and inputs provided by informal firms to keep their production costs down and to remain afloat in the increasingly competitive marketplace. Accordingly, any attempt to ease regulations and laws intended to entice informal enterprises to formalize could backfire, leading to competitive formal enterprises and little movement toward a smaller informal economy.

The structuralist advocates promote a relaxation of labor codes that make it easier to hire, maintain, and fire formal workers in formal firms, promote capital investment in modern industrial and service sectors, and focus on existing community networks of merchants and

314. Id., at 1.

315. Id., at 2.

316. BRYAN R. ROBERTS, *Employment Structure, Life Cycle, and Life Chances: Formal and Informal Sectors in Guadalajara* 49 (Alejandro Portes and Manuel Schaubler ed., 1989).

workers to facilitate formalization. While they do not expand upon how these investments and revisions would take place, they indicate that policy in this area should see the informal economy as a development of modern capitalism rather than a distinct and unique phenomenon, which should drive policymakers to examine how any change in law or policy toward labor or business may impact both the formal sector's competitiveness, and the informal sector's ability to participate productively in the marketplace.³¹⁷ "In fact, it is because there is a formal economy...that we can speak of an "informal" one."³¹⁸

Portes and Castells³¹⁹ note that suppliers of commodities that formal firms rely upon are often informal, keeping the cost of those inputs low.³²⁰ In their estimation, the informal economy exists and thrives for three principal reasons: 1) organized labor grew in power, pushing more firms to resort to subcontracting rather than paying higher wages and benefits; 2) increased state regulation of business and labor, increasing costs for doing business; and, 3) increasing international competition, driving developing country firms to seek avenues for reducing production costs.³²¹ This, according to the authors, has led to a perverse scenario – capitalism, rather than diminishing the existence of the informal economy, has seen fit to capitalize on the low costs of informal production.³²² "By lowering the cost of labor and

317. See also, PERRY, et al., 44. (explaining how large firms use informal labor and small firms to sidestep labor regulations and adjust to increasing global competition).

318. MANUEL CASTELLS AND ALEJANDRO PORTES, *World Underneath: The Origins, Dynamics, and Effects of the Informal Economy*, 13 (Manuel Castells Alejandro Portes ed., 1989).

319. ALEJANDRO PORTES, et al., *The Informal Economy: Studies in Advanced and Less Developed Countries* (Johns Hopkins University. 1989).

320. Id.

321. Id. at 27-28.

322. Id. at 29. (noting the comparative advantage that informal production gives to newly industrialized countries).

reducing the state-imposed constraints on its free hiring and dismissal, the informal economy contributes directly to the profitability of capital.”³²³

A recent report authored jointly by the World Trade Organization and the International Labor Organization echoes some of what Portes and Castells suggest. Looking through the lens of foreign trade and examining the impact of increased trade on informality, the authors argue that most developing countries experience increases in informality as they open their markets to foreign trade and investment. The reason for this phenomenon is that many small firms in developing countries operate with minimal productivity, limited technology, and heavy reliance on labor, all of which make them less competitive in the face of foreign competition.

According to the report, the informal economy acts as a buffer to help workers survive when they lose their jobs due to increased foreign competition. It also serves as a potential magnet for foreign firms looking for cheap labor inputs, such as through the establishment of export processing zones where foreign firms can capitalize on lower labor costs in assembling their goods for immediate export. Yet these advantages of the informal economy are outweighed significantly by the negative impact on economic development and full integration into the world economy. Developing countries should instead focus on policy reforms that provide a set of positive incentives for formalization and that protect workers that might be affected by increased foreign trade.

323. *Id.* at 30.

The Dual-Track Approach

In theory, both the deregulatory and the structural change approaches appear logical. Both focus on much needed regulatory reform and improvements in the labor market to entice informal firms to formalize. Yet neither has successfully captured the dynamics of the informal economy in practice. A more recent approach opens the possibility of viewing the informal economy itself as a dualistic economy, suggesting the need for a bifurcated policy approach.

In a recent study, Gary Fields explains that the low barriers to entry to informal work make it an attractive option for nearly any unemployed or underemployed individual.³²⁴ However, unlike some theorists who propose that the informal economy is a homogenous concoction of desperate and poor workers, Fields suggests that it is heterogeneous and made up of workers that have no choice but to take informal employment, as well as those that choose to work informally. Fields suggests that “some informal activities are preferable to formal sector jobs and some are not.”³²⁵

Fields divides the informal marketplace into two tiers of individuals. The “upper-tier” consists of those workers and firms that see value in skirting the state to earn a profit, either through avoidance of taxes and business registration fees, or through payment of minimal wages and benefits to employees. Within the lower-tier, which he labels the “easy entry” segment, individuals meet their basic needs through occasional and often survivalist jobs, such as street vending and domestic services. Dividing the informal economy in this way significantly impacts the potential success of a solution to informal economy expansion. “Upper-tier” firms

324 FIELDS.

325. Id.

and workers will likely respond less favorably to an improvement in state-funded social security, pensions, and health insurance in return for formal registration and taxation, since they are profiting from the avoidance of taxes and fees and using their extra income to fund their basic needs as they see fit. “Easy entry” workers and firms may respond less favorably to regulatory streamlining and access to credit since they are struggling to meet their own basic needs and would welcome most opportunities for formal work as long as they included stable and sustainable income and benefits. Thus, for Fields, a combination of business promotion and expanded formal job opportunities may be the most reasonable solution to the problem of rising informality.

In the 2007 World Bank report on Latin America and the Caribbean, the authors divide the informal economy into those individuals and firms that have been excluded from formal opportunities as a result of high unemployment, low skills and education, or other barriers to entry, and those individuals and firms that have exited the formal market due to perceived benefits of becoming informal, such as tax evasion, flexible working hours, and avoidance of rigid labor and business regulations.³²⁶

According to the report, regardless of the reason for locating in the informal economy, unified efforts should be made to lessen the harmful effects of operating outside the purview of state control. “Whether because of outright exclusion and market segmentation or massive voluntary opting out of formality, informality may lead to a suboptimal social equilibrium in which many workers go unprotected from health and employment shocks and from poverty in old age.”³²⁷ Categorizing the informal sector as largely heterogeneous, with workers

326. PERRY, et al., at 2.

327. Id. at 7.

experiencing both exit and exclusion at varying levels, the authors surmise that exit and exclusion should be viewed as complementary outcomes and addressed together.³²⁸

The Tax Reform Approach

A third potential rationale for operating in the informal economy and thus a third focal area of reform is taxation. The collection of tax revenue by states in Latin America has consistently wreaked havoc on budgets and fiscal stability. The vast majority of income from taxation in Latin America comes from domestic and internationally traded goods and services, yielding roughly 60 percent of tax revenue. Revenue from income taxes totals approximately 30 percent, with 18 percent coming from corporate taxes (mostly medium and large firms) and only 6 percent coming from individual income tax payments. Individual income tax payments constitute the bulk of tax revenue in North America (83 percent) and a substantial portion of revenue in Western Europe (47 percent).³²⁹

The tax system in Latin America is complicated and expensive. With corporate taxes constituting the bulk of the income tax revenue received by the state, firms perceive that the state is unable to comprehensively enforce individual income tax collections and, as a result, places a heavy burden on formal firms to supply the much needed tax revenue for the state.³³⁰ Recognizing this weak enforcement, some firms may attempt to take advantage of the ability to operate informally and avoid payment of taxes to the state. While in no way operating without

328. Id. at 47.

329. Id. at 223-25.

330. See, e.g., Id. at 224.

any cost to third parties,³³¹ the savings earned by working informally may permit the firm to retain adequate profits in order to survive in the marketplace.

According to the World Bank, “[t]ax compliance is one of the main components of the decision to engage in the formal economy.”³³² The state is responsible for establishing a tax code, enforcing that code, and putting the collected revenues to work for the state. If a state is not perceived by its citizens to be using the collected revenues productively, or if the distribution of benefits is unequal, some citizens may feel disenfranchised and may opt to stop paying taxes in protest.

The World Bank suggests that there is a correlation between a negative perception of the equitable use of tax revenue and informality.³³³ The less value individuals perceive in paying their taxes, measured by indicators for government effectiveness, rule of law, and impartiality of courts, the less likely they are to pay taxes. A state is limited in its actions by the tax base and its ability to enforce its tax laws. Its accomplishments are equally limited by the amount of revenue collected. As a result, perceptions of inadequacy abound as states appear to do little with their tax revenues. This perception yields a greater number of individuals that choose to avoid paying taxes, which according to the World Bank, may increase the size of the informal economy. This, of course, creates a cycle of growing informality and tax evasion, accompanied by declining tax revenue. The World Bank suggests that the higher the level of taxation, the higher the level of informality or, tax avoidance.³³⁴

331. See, e.g., SOTO, *The Other Path: The Economic Answer to Terrorism* 154. (finding that most informal firms must pay significant bribes and other fees to security services, tax collectors, and police, in order to operate informally).

332. PERRY, et al., at 223.

333. *Id.* at 240.

334. *Id.* at 227.

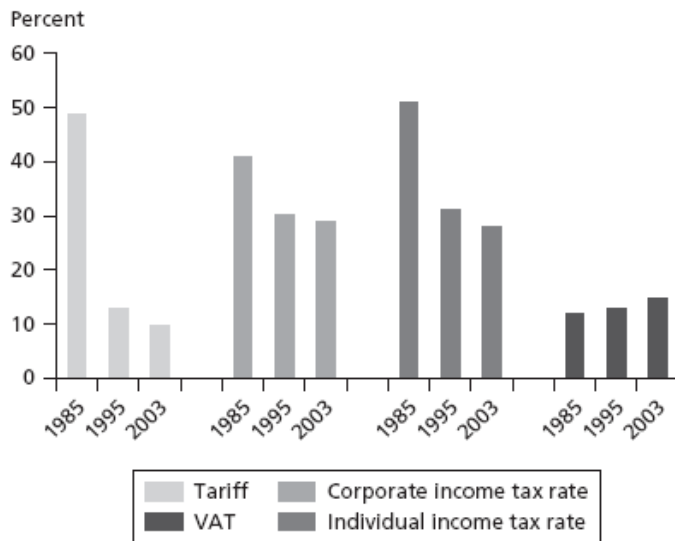


Figure 16. Average tax rate of the Latin America and Caribbean region.
Source: World Bank (2007).

The World Bank suggests that the best mechanism to reform the low rates of tax collection is deterrence.³³⁵ “[C]ompliance with taxes – and presumably with most regulations – will depend on the economic consequences of detection and punishment”.³³⁶ However, they recognize the difficulty in determining levels of risk aversion and how to use deterrence to change the incentivized avoidance system. Thus, they turn their attention to the attitude of the individual taxpayers toward the state. Viewing taxation as a contract between the state and the individual, an individual only feels obligated to complete their obligations under the contract if the state completes their respective obligations. Weak states often prove unable to provide the services that citizens expect, such as safe and reliable infrastructure, public transportation, healthcare, and access to justice. This can lead to a rebellion against the state and a boycott of taxes.

Recent studies by the former Executive Director of the Colombian development agency, Fedesarrollo, Mauricio Cárdenas, who is the current Brookings Latin America Initiative Director,

335. Id. at 226-27.

336. Id. at 227.

attempt to clarify the nature of the Colombian informal economy, and the broader context for growth in Latin American informal economies. After a careful review of some key authors, such as de Soto and Loayza, and after reviewing studies on the informal economy conducted by the Colombian statistics agency, DANE, Cárdenas concludes that the evidence of growing informality is likely the result of the tax structure, particularly, regulatory fees and a complicated tax code.³³⁷ Small businesses are at a significant disadvantage in their ability to understand the tax code and to take advantage of the numerous exceptions that often require legal assistance to comprehend.³³⁸

The Microenterprise Promotion Approach

A fourth mechanism, favored by many states and promoted by several authors, is to increase investment in microenterprise development. By reconceptualizing the formalization process as small business promotion, there is a greater likelihood that the private sector and trade-oriented institutions will have an interest in participating in the process. While formalization is a vague and inconclusive term, “small business promotion” rings of capitalist progress and economic achievement.

Microenterprises are defined differently by different states and different entities, but in a broad sense, they are small businesses, often employing less than 10 individuals, producing or

337. MEJIA.

338. *Id.*, at 20-21.

selling legal goods or services on the open market.³³⁹ In many cases, these are family-owned and operated businesses or sole proprietorships.

If the informal economy is perceived as, at least in part, made up of entrepreneurs that operate unlicensed and unregulated businesses in order to cut costs and avoid reporting requirements, the promotion of small enterprises may work to bring more informal firms under the umbrella of formal protection. Victor Tokman discusses this as a modernization process, whereby the state would facilitate the microenterprise's access to the market and provide them with productive resources, credit, and training, in order to encourage them to come under the formal structure of the state.³⁴⁰ In his view, combining small enterprise modernization with social protection for informal workers and easing regulatory burdens on formal sector activities, will have a positive formalizing effect and reduce some of the negative externalities of remaining informal.³⁴¹

Microenterprise promotion is often combined with deregulation and tax reform approaches in an effort to generate new opportunities for small business development and growth. Politically, it is more appealing to promote policies that encourage small business development than it is to revise the tax code or untangle the regulatory jungle.

339. In Colombia, a distinction is made between small enterprises (pymes) and microenterprises (mipymes).

340. TOKMAN, *Integrating the Informal Sector in the Modernization Process*, 3.

341. *Id.*, at 3-4.

Conclusion

Developing states and development institutions have recently come to accept the significant impact that a large and growing informal economy can have on economic growth and development. As the informal economy grows, tax revenue diminishes, productivity falls, and the number of individuals in poverty and dependent upon basic social services increases, further draining state resources at the expense of necessary development projects. In addition, as noted by the new WTO/ ILO report, the impact of informality on integration into the world economy is significant and may be yet another reason for developing countries to consider strategies to reduce informality.³⁴² Yet while it appears clear that there are multiple pathways toward reducing informality in theory, little evidence exists as to the success of any of these approaches.

Formalization via the mechanisms discussed in this chapter face the problem of lack of demand for what they offer—namely, state services and rule of law. These approaches may offer a temporary remedy that helps some informal firms at least temporarily leave the informal economy, but they do not establish a stable and consistent pathway toward a culture of formality and fail to address the root causes of informality. In addition, because the informal economy is highly competitive internally and maintains some barriers to new firm entry, the movement of an informal firm to the formal sector without addressing the informal firm rationale creates an opportunity for the establishment of another informal firm in its place, offsetting the gains made by the formalization of the former informal firm.

342. Globalization and Informal Jobs in Developing Countries.

This is not to say that microenterprise promotion or any of the other mechanisms herein described are bad policies. Streamlining business regulations and simplifying the tax and labor codes create significant efficiency gains for formal and informal firms alike and should be pursued in line with the country's development goals. However, these strategies alone may be insufficient to overcome the culture of informality that protrudes from most developing country markets.

A fitting thought to close this chapter comes from Portes and Castells, who laid the framework for this reconceptualization of the wisdom of formalization. "In the real world...there is nothing ironic about the informal economy, for the livelihood of millions depends on its existence, and the future of many societies, on its form of evolution."³⁴³ The way forward may not be found in the short-term carrot and stick approach, but rather it may require attention to the role of the informal economy in the country's development trajectory.

343. PORTES, et al., *The Informal Economy: Studies in Advanced and Less Developed Countries* 33.

Chapter 11: Illusions of Productivity Gains

Introduction

The third and final objection to current formalization policies is that they assume a link between formalization and improvements in firm productivity. Despite frequent, undisputed assertions that formal firms are more productive than informal firms, no data successfully shows productivity gains for a small business that formalizes.

One of the key selling points of formalization for developing states is the potential for it to increase the productivity of small firms and expand the tax revenue base of the state. The basic idea is that informal firms are unable to increase their capital investment because they lack access to capital, that they cannot benefit from mass production efficiencies because they risk being harassed by the state if they grow larger, and that they cannot expand their business operation legitimately because they cannot afford the time and money needed to obtain a license. If business registration processes are streamlined, licenses become more affordable, and access to capital becomes easier, informal firms will become a productive part of the formal economy.

However, as I argue in the following pages, formalization will have little, if any, impact on the productivity of an informal firm. Most informal firms survive by selling goods or services at lower prices than formal merchants. They can afford to charge lower prices that attract some

clients because they do not generally pay taxes on their sales, may have illicitly obtained their inventory at a below wholesale price, and avoid other payments to the state, such as social security and health insurance, for their workers or themselves. If the firm were required to incur these additional costs, they would either lose their competitive edge against established formal firms, or become short-lived and unproductive formal firms. To obtain a license with the state, a firm must be willing to comply with state laws and regulations, including those that would apply these costs to the firm. Accordingly, not only is it too expensive for a firm to obtain a license to operate, it is too expensive to operate with a license at all. To suggest that lower operating taxes and license fees will allow informal firms to become productive members of the formal economy ignores the fact that the main reason informal firms survive today is because of their avoidance of formality.

Firm informality has often been associated with low productivity.³⁴⁴ At the firm level, this is due to the small size, limited skill, and minimal capital investment indicative of most small firms. In the informal economy, small firms generally remain small in order to avoid being detected by authorities and also because they may not have the resources to expand to a larger scale operation.

But productivity gains from formalization could also come from the elimination of the informal firm, which would relieve competitive pressure from formal firms with which they compete. The informal firm is able to operate with less overhead and fewer input costs due to the fact that it generally has no fixed space to rent, and it can obtain and sell its goods without paying associated taxes and fees. In addition, in some contexts, informal firms can purchase

344. See, e.g., FARRELL, *The Hidden Dangers of the Informal Economy*. see also ALC R. LEVENSON & WILLIAM F. MALONEY, *The Informal Sector, Firm Dynamics and Institutional Participation*, World Bank Policy Research Working Paper (1998).

goods as individuals rather than firms, earning a discount from the supplier and further undercutting their formal competition.³⁴⁵

At the international level, informal firms are criticized for their role in deterring foreign investment. Informal firms are largely associated with theft of intellectual property, including selling goods in violation of intellectual property laws. Accordingly, foreign investors fear that their innovations and technology would be at risk if they were exposed to a market that includes a vast informal sector. This fear may limit some foreign competition and also restrict potentially lucrative international trade.

In this chapter, I will evaluate the validity of the assertion that formalization will improve productivity by examining potential areas of improved productivity, as well as efforts to enhance competitiveness and economic development.

Effects on Economic Growth and Development

It is rare, though not unheard of, to find a large informal firm operating in a developing country. While there are instances of formal firms engaging in semi-formal practices, such as hiring informal labor off the books or failing to report some earnings, most completely unregistered firms are small.

There are several reasons why an informal firm would choose to operate on a small scale. Among these, it may have limited resources to invest in the firm at the outset. An intending street vendor may begin their firm by carrying baskets of fruit to sell because she is

345. In Colombia, for instance, informal vendors of cellular phone minutes often undercut formal firms by purchasing minutes as individuals and selling them at a lower cost than firms, which pay a business rate.

unable to procure a vending cart right away. The owner of the firm may have few economically valuable skills and thus may have to resort to small scale operations to meet the limited demand (or flooded supply) of her good or service.

Frequently, an informal firm operates on a small scale to avoid detection by enforcement authorities. If tax enforcement authorities were to easily identify an informal firm, they might harass, fine, or seek bribes from that firm. As the firm becomes larger, it becomes more obvious and also represents higher profits, which means more potential duty for the inspector to collect. Due to limited enforcement resources, most inspectors prefer larger and more successful targets.

In his highly popular book, *The Other Path*, Hernando de Soto explains that informal firms remain unregistered due to the high cost of entry into the formal marketplace. This includes the cost of taxation, annual licensing fees, reporting requirements, and operational regulations that require the payment of social security and health care for workers, for instance. An informal firm already operates at the margin of profitability, and payment of these exorbitant fees would undoubtedly destroy the firm.

An analysis of World Bank and USAID survey data conducted in 2002 by Djankov, La Porta, Lopez-de-Silanes and Shleifer, echoed de Soto's assertion that higher barriers to entry through complicated regulatory systems are associated with a larger informal economy.³⁴⁶ They concluded that higher barriers to entry tend to be created by governments under a public choice theory by which the bureaucratic steps are intended to benefit politicians and bureaucrats. They found that these regulatory barriers have no social value.³⁴⁷

346. SIMEON DJANKOV, et al., *The Regulation of Entry*, 117 *Quarterly Journal of Economics*, 1 (2002).

347. *Id.*, at 3.

These findings do not coincide with the conclusion that informal firms would be more productive if they were able to overcome these barriers and enter the formal economy. In a recent paper by Rafael La Porta and Andrei Shleifer, for instance, the authors criticize de Soto's entrepreneurial argument, which asserts that informal firms aspire to be more productive but cannot due to these regulatory barriers to entry in the formal marketplace that would drain all potential profitability. Instead, they contend that any informal firm would still be profitable once it had registered if it were confident that it could achieve productivity gains by being formal. They use World Bank Enterprise Survey data to analyze the productivity of unregistered versus registered firms. They find that in nearly all instances, existing registered firms are more productive than unregistered firms, and large firms are more productive than small firms.³⁴⁸ Taxes and regulatory barriers are not preventing firms from becoming formal and improving their productivity, according to this survey.

Whereas de Soto sees informal firms as frustrated entrepreneurs waiting for their opportunity to explode onto the formal market, La Porta and Shleifer find them to be uncompetitive in either sector of the economy: "[t]he image of unregistered firms consistent with their observed levels of productivity is not that of predators but rather that of relics of the past."³⁴⁹

Perry and Maloney pick up this argument in their analysis of the Latin American informal economy.³⁵⁰ They suggest that informal firms tend to occupy the least regulated sectors, largely due to their limited skills and inability to achieve profitability in the face of state laws and regulations. Their only interest in joining the formal economy comes from a desire to avoid

348. SHLEIFER, 26-27.

349. *Id.*, at 28.

350. PERRY, et al., 171-75.

finances and bribes, rather than any significant interest in the asserted formalization benefits of property protection, contract enforcement, and market access.³⁵¹

Perry and Maloney contend that informal firms, while unproductive themselves, also impact the productivity of the broader economy. In the broader economy, informal firms tend to restrict the operation of the capitalist doctrine of creative destruction, allowing new firms to rise up to seize new market opportunities. Also, high levels of informality may restrict the willingness of formal firms to adopt new technology or innovative techniques that could be improperly requisitioned by informal firms.

The idea of creative destruction can be traced to Joseph Schumpeter who, in 1943, argued that the capitalist system is not static, but rather is a dynamic economic environment. He said, “[c]apitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary...The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers’ goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates.”³⁵² If formal firms are limited in the new technologies that they are willing to adopt due to a large informal sector, according to this logic, then the informal economy is negatively impacting capitalist development.

For Perry and Maloney, the informal economy may be standing in the way of the creative destruction process by allowing small, unproductive firms to compete with small, formal firms that face higher operating costs. But in exchange for those higher operating costs, the formal firms may have the ability to grow into productive, innovative firms. The informal

351. Id. 171.

352. SCHUMPETER, 82-83.

economy, then, holds back potentially innovative formal firms.³⁵³ Of course, this argument fails to take into account the cross-breeding between the formal and informal sectors that may allow small registered firms to take advantage of low cost inputs, marketing, labor, and distribution of their goods or services via the informal economy. So, while informal firms may undercut the potential of a formal firm to rapidly accelerate to profitability, they may also facilitate that development through lower cost labor and supplies.

Innovation and technology can help a firm to become more productive by increasing efficiency and output without increasing labor input. As informal firms are associated with the theft of technology through piracy and reverse engineering, formal firms are hesitant to engage in extensive innovation or investments in technology. This withdrawal from innovative practices can reduce the productivity potential of a formal firm and limit overall economic growth.

Informal firms are also limited in the application of technology and innovation to their own operations. With little capital to invest and little skill to apply, an informal firm often resorts to outdated production techniques and devices to run their business. In many developing countries, this is visible among street traders and marketplaces where even basic goods such as electricity and clean water are lacking.

The Importance of Productivity

Productivity refers to how efficiently productive inputs are being used to produce a given level of output.³⁵⁴ It measures the change in units of output for every unit of labor and capital invested. According to Paul Krugman, measuring productivity is essential to develop an

353. PERRY, et al., at 171.

354. Measurement of Aggregate and Industry-Level Productivity Growth. (2001).

understanding of economic growth. “Productivity isn’t everything, but in the long run it is almost everything. A country’s ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker.”³⁵⁵ According to survey data by Perry and Maloney, new informal firms in Latin America operate at the lowest level of productivity. Registered firms are 29 percent more labor productive than unregistered firms, according to this study.³⁵⁶

While there is broad agreement that formal firms are more productive than informal firms, there is less agreement that this unproductivity results from being informal, that is, not registered with the state, or that unproductivity will dissipate if that firm becomes formal. Even Perry and Maloney concede this point: “Despite the widespread belief that a large informal economy hurts economic growth, cross-country comparisons do not find a robust association between informality and growth.”³⁵⁷

Most small firms, formal or informal, face challenges in accessing credit markets, marketing their goods and services, investing in supplies and technology, and renting space and equipment. The tradeoff for formal firms is taxation and regulation in exchange for a business license and potentially easier access to the tools that might enhance their productivity. Creating a formal operation is a risky endeavor and usually requires some initial capital investment, skill, or market connections, to be worth the tradeoff. Most informal firms have little skill or capital to invest in their operation. The risk of formalization, then, is too high given the uncertain potential for increased access to the tools of productive development.

355. PAUL KRUGMAN, *THE AGE OF DIMINISHING EXPECTATIONS* (1994).

356. PERRY, et al., at 173.

357. *Id.* at 172.

A recent survey of Lima conducted by the German Development Institute surveyed informal firms and asked them about the bases for becoming formal or remaining informal. Interestingly, they found that access to credit was a relatively minor (6 percent of all surveyed firms) reason to obtain a license, whereas becoming legal (44 percent) and avoiding fines (27 percent) were more on the minds of informal firms.³⁵⁸ These results are consistent with Perry and Maloney, who found that only 8 percent of surveyed firms rated access to credit as the principal reason to formalize, whereas complying with the law (47 percent) and avoiding fines and bribes (29 percent) ranked much higher.³⁵⁹

These results indicate that access to credit, one of the key tools to improving productivity and a promoted benefit of formalization, is not perceived by informal firms as sufficiently valuable to formalize. The principal interest for informal firms is avoiding problems with the law and with law enforcement, which are the principal barriers to sustainable economic activity. If the goal of formalization for the state is to increase productivity of the informal firm, yet the goal of formalization for the informal firm is to avoid fines and comply with the law, any expectation of increased productivity through access to credit may be misplaced.

Productivity and Economic Development

Large informal economies are generally found in developing countries and they tend to dissipate as those economies merge with developed economies. In Chile, for instance, where economic development has been highly successful in recent years, the informal economy

358. MIGUEL JARAMILLO, *Is there Demand for Formality among Informal Firms*, 12 German Development Institute Discussion Paper, at 8-9 (2009).

359. PERRY, et al., at 162.

occupies no more than 20 percent of the overall economy, as compared to an average of over 40 percent throughout the region.³⁶⁰ Yet Bolivia, one of the least developed Latin American countries, maintains an informal economy that near 70 percent of the working population comprises. The association between large informal economies and lower levels of economic development has led many states to pursue aggressive formalization policies to rid their states of this drain on growth.

Economic development, following Simon Kuznets' theory, refers to growth accompanied by changes in the structure of production and employment. "A country's economic growth may be defined as a long-term rise in capacity to supply increasingly diverse economic goods to its population, this growing capacity based on advancing technology and the institutional and ideological adjustments that it demands."³⁶¹ Kuznets was careful to delink economic growth from a rise in national income.³⁶² His economic growth definition is largely associated with the concept of economic development today.³⁶³

The idea of economic development has come to be associated with advances in technology, modernization, and individual rights and freedoms, most often expressed in the form of democracy. The idea of modernization, popularized by Nobel laureate Gunnar Myrdal, contends that several key elements are required to achieve economic development: rationality and the application of technology to social relations; development planning; increases in productivity; improvements in the standard of living; reduction in inequality; more efficient

360. Id. at 29.

361. SIMON KUZNETS, *Modern Economic Growth: Findings and Reflections* (1971).

362. SIMON KUZNETS, *National Income, 1929-1932* 7 (1934).

363. See, e.g., ADAM SZIRMAI, *The Dynamics of Socio-Economic Development* 6 (Cambridge. 2005).

institutions; state consolidation and independence; democratization; and increased social discipline, which appears to be closely linked to the rule of law.³⁶⁴

In a more recent description of economic development, Amartya Sen argued that the expansion of freedoms was an essential element in development. In his 1999 work, *Development as Freedom*, Sen contends that every advance should be measured in terms of the freedoms that it promotes. These freedoms include the freedom to do certain things, such as the freedom to engage in economic activity, as well as freedom from certain things, such as freedom from slavery. He argues that freedoms serve as both means and ends and that economic growth for its own sake should be tempered by an analysis of what is sought to be achieved.³⁶⁵

Eliminating the informal economy as a means of promoting productivity and economic growth tends to conflict with the goals of economic development asserted by Myrdal and Sen. To some degree, the existence of an informal economy provides a sustainable livelihood for millions of individuals. These unregistered business activities reduce (or at least do not worsen) inequality by capturing some of the rents that would otherwise be directed toward the middle and upper classes. And they provide efficient institutions, including informal dispute resolution mechanisms, which the state is unable to provide.

Following Sen's logic, informal firms are trying to pursue economic exchange in order to meet their basic survival needs. They are capitalizing on legal failures, such as weak law enforcement and complicated registration regulations, by engaging in business activity to provide sustainable income when the formal market cannot. While perhaps not entrepreneurial

364. GUNNAR MYRDAL, *ASIAN DRAMA: AN INQUIRY INTO THE POVERTY OF NATIONS* (1968).

365. AMARTYA SEN, *Development as Freedom* (Anchor Books. 1999).

in all cases, informal firms use creative and often aggressive means to continue their life-sustaining activities. Tighter enforcement of laws that would prevent their merchant activities, and more barriers to entry into the formal marketplace may limit the freedom of these firms to meet the basic needs of their owners. The end goal of promoting a fully-formal economy consisting of only productive firms is aligned with capitalist development; yet the means to achieve that goal cannot be through the elimination of the informal sector. To do so would be to trade freedom for perceived gains in productivity.

Effects on Competition

A competitive business environment can contribute to innovation, creative destruction, and ultimately, lower prices for consumers. Consider, for instance, the OECD position on the value of competition in promoting economic growth: “The strength of product market competition plays an important role in economic growth and affects economic efficiency, the allocation of resources, and can also lead to improved labour market performance.”³⁶⁶ Full and fair competition is a cornerstone of capitalist development.

Schumpeter claimed that perfect competition was unrealistic and that it should not be the ultimate goal of economic development policies. Competition should come not only from lower prices, but also from the creation of dynamic efficiencies. He suggested that truly revolutionary competition comes from new products, new technology, new sources of supply,

366. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *OECD Competition web site*, at www.oecd.org/eco/structural/competition.

and new types of organization.³⁶⁷ For him, some monopoly power was permissible and even beneficial to the economy as it allowed certain firms adequate profit to reinvest in innovative ideas, research and development.

The informal economy is sometimes considered to be market distorting because of its impact on competition with formal firms. According to the McKinsey Global Institute, “[c]ompetition is therefore distorted because inefficient informal players stay in business and prevent more productive, formal companies from gaining market share.”³⁶⁸ This argument suggests that less productive informal firms, which are able to operate at a lower cost due to lack of overhead, lack of taxation and license fees, and broader market access due to mobility, are undercutting formal firms in the same sector.

From a practical perspective, any potential distortion in competition caused by informal firms is limited by the scope of industries in which informal firms tend to participate. For instance, informal firms rarely operate in high-tech sales, health services, education, and skilled labor industries.³⁶⁹ However, they can harm formal firms that sell basic consumer goods, provide repair services, cleaning services, food, and transportation. But informal firms can also benefit formal firms that source their supplies or services from informal firms, such as a formal ice cream manufacturer that uses informal vendors to distribute its products widely, or a professional office that relies on informal firms for catering or cleaning services.

Perry and Maloney contend that, while it is indeed possible that informal firms affect the competitiveness of formal firms, it is also possible that they facilitate their lifespan. Formal

367. SCHUMPETER, at 84.

368. FARRELL, *The Hidden Dangers of the Informal Economy*.

369. See, e.g., PERRY, et al., at 171. (arguing that small informal firms tend to locate in industries where efficiency losses for small scale production are minimal).

firms that develop or import new technology are often at the mercy of informal firms that impede on the monopoly power of that firm by broadly disseminating that technology through theft, piracy, or reverse engineering. However, while it loses market share, the firm is also able to more widely disseminate its products, facilitating increased demand for its goods. The small formal firms that may have been less competitive in the face of large manufacturers also benefit by being able to remain active in the marketplace thanks to informal firm competition with larger firms.³⁷⁰

Within the informal sector, competition can play a significant role in determining the success or failure of a business venture. As Jose Itzigsohn argues, cooperation is necessary for the survival of informal businesses, yet the institutions necessary to facilitate that cooperation malfunction or do not exist in many developing countries.³⁷¹ Strong competition within the small business community, largely occupied by informal enterprises, can lead to aggressive pricing and threats to the development of a vibrant small business economy. However, as de Soto's research, as well as my own, suggest, many informal firms collaborate to discern time and geographic limitations on their jurisdiction in order to maximize profit-making opportunities.³⁷² Informal firms often form cooperatives and other organizations to promote their interests or protect their assets and they tend to share the goal of protecting their market.

Informal firms remain competitive because they operate outside the law, without paying the fees and taxes that formal firms are subject to. This competition might deter a small firm operating in a low-skilled labor sector, such as basic vending or repair services, from

370. Id. at 172.

371. JOSE ITZIGSHON, *Neoliberalism, Markets, and Informal Grassroots Economies* 90-91 (Patricia Fernandez-Kelly & Jon Shefner eds., 2006).

372. SOTO, *The Mystery of Capital* at 163.

formalizing and facing potentially crushing operating costs. But these firms are also often used as stepping stones for more skilled or innovative businesses as a way to cut costs. A formal restaurant owner, for instance, might rely on informal firms to supply his ingredients and perhaps provide cleaning or construction services, saving costs that would otherwise have prevented that formal firm from starting his business.

The conclusion from this discussion is that the impact of informality on formal firm competition is not always going to be negative. Informal firms facilitate low-cost supplies, and expand the scope of new product distribution, while simultaneously undercutting larger firms, stealing technology, and deterring innovation.

Conclusion

The informal economy can facilitate or weaken productivity. It may hurt productivity by limiting the opportunities of small, formal firms to compete and contribute to the broader economy. It may threaten fair competition through theft of ideas, unfairly priced goods and services due to avoidance of taxation, and unlawful sales of goods outside the regulatory boundaries of the state. It may also threaten productive investment as high-tech or innovative foreign companies may choose not to locate in countries where the threat of technology theft is high.

Yet informal firms may also improve productivity in the marketplace by offering low-cost labor and inputs to formal firms, helping firms reach a broader client base, and attracting some foreign investment, especially in labor intensive industries such as natural resources extraction and construction.

Clearly, the more effective model for growth is to develop an economy ripe with productive firms, fair competition, low theft of technology, and skilled workers. But what the arguments above have hopefully conveyed is that these goals require attention to education, improvements in legal institutions, and investment in productive sectors, rather than efforts to formalize small informal firms that would have a minimal impact on the achievement of these goals.

The problem of low productivity and unfair competition drives states and international institutions to promote formalization as a solution to their economic growth woes. Formalization involves the registration, taxation, and regulation of the firm. If the problem of low productivity and competitiveness is rooted in the skill level and limited resources of the informal firm, changes in registration, taxation, and regulation are unlikely to have any positive effect on their productivity or on economic growth. More appropriate solutions, such as temporary licensing, training, and targeted investing, will be discussed in the final chapter.

Part IV: Conclusions and Recommendations

Chapter 12: Conclusions and Recommendations

What I have attempted to show in the preceding chapters is that the present approach to firm formalization is unlikely to succeed in reducing the growth of the informal economy because it fails to account for the broken social contract between the state and the informal economy. A critical re-evaluation of this approach is necessary if developing countries expect to capture a larger share of global economic growth through the development of a modern and vibrant economy.

The push for formalization in developing countries is on. Increasing pressure from multinational firms, international institutions, and even some domestic firms, is driving states to aggressively pursue laws and policies that streamline business, open the door to foreign trade, and enhance domestic growth and productivity. Cleansing the domestic marketplace of the informal economy through formalization programs has taken a prominent role in this process.

Once the entrepreneurial veil is lifted and we see the informal economy for what it is, formalization as it is currently conceived becomes unnecessary, and even wasteful. The associated business development initiatives benefit existing or intending formal businesses, not informal firms. The process of incentivizing informal firms through tax reductions, registration assistance, and access to credit, will not, as a general policy, succeed in promoting the creation of productive firms and reducing the size of the informal economy.

However, formalization in a broad sense is still a desirable outcome. Formalization signifies a unified rule of law culture, which promotes efficient exchange and a set of productive

economic and legal institutions; a broader tax base to fund state development programs; and a regulated environment that allows the state to effectively protect the safety of its citizens.

Most firms and workers in the informal economy are poor, lack valuable assets, education, and skill, and operate on the margin of survival. Effective formalization programs must recognize the characteristics of the typical informal firm and work to protect these individuals not only with economic opportunity, but also with social insurance.

To succeed in achieving these long-term desirable outcomes, states must put aside the current economic-incentive based approach to formalization and adopt an enabling approach that capitalizes on the existing institutions and efficiencies within the informal economy while providing informal firms with access to benefits that will promote their economic well-being and offer them opportunities to grow.

In order to effectively temper the negative impact of the informal economy on the overall economy, states must first recognize the dual nature of informal firms. Firms operating in the informal economy use illegally acquired public space to sell often illegitimately acquired goods or provide unregulated services and report little or no income to the state. They place themselves and potentially other citizens at risk by failing to adhere to safety standards, be accountable for their actions, or protect their enterprise. They are largely unskilled, small, and unproductive businesses that have only indirect relationships to the economic growth potential of the state. Yet, these firms are essential to the economy and to the state's overall economic development success.

If the state were to wipe out informal firms by significantly ramping up law enforcement, increasing penalties for operating a business without a license, or expend significant resources on tax collection, the overall economy would suffer. Unemployment rates

would soar and out of work, formerly informal business proprietors would become a substantial burden on state social services. Yet there would be little increase in the number of formal firms contributing taxes to fund these social programs or provide jobs for the newly unemployed. States with substantial informal economies would have a difficult time surviving financially if they were to eliminate their informal economies.

Yet as discussed above, formalization as it is currently modeled has little hope of turning informal firms into productive, formal enterprises. The few lower-tier firms that take advantage of tax incentives and short-term business opportunities in the formal sector are unlikely to remain formal in the face of increasing costs in the long-run. Those that do remain may have a negligible impact on tax revenue for the state and they likely would have chosen formality voluntarily when they acquired adequate resources regardless of the formalization program.

In the face of this bifurcated economic and legal environment, states should begin to develop programs that attack the root causes of informality and the negative associations of being a part of the informal economy. In other words, states must re-examine the terms of the social contract and work toward eliminating the health and safety risks of informal business in an effort to unify the shared formal and informal goals of economic survival.

Renegotiating the Social Contract

One of the root causes of firm informality is the failed social contract between informal firms and the state. The development of a formal rule of law culture that protects the propertied class, and the growth of economic and legal institutions to support this culture, has excluded a significant portion of the economically-active population. The resulting agreement

between the state and its citizens is largely balanced in favor of those with valuable assets. In order to receive protection from the state for those assets, an individual needs to cede some personal freedoms by abiding by state laws. Although this bargain seems reasonable within an industrialized country where most citizens enjoy some asset ownership and live in a culture with widespread rule of law, abandonment of these freedoms in a developing country may mean the demise of a principal source of income. The costs of ceding freedoms such as the freedom to operate in public space, without paying taxes, and without maintaining a license, are too high for most informal firms. For most informal firms, formalization is an unnecessary input to their operation.³⁷³

For the state to succeed in expanding the number of parties to their social contract, which will expand the net of formal rule of law, they need to modify the bargain to include benefits that those with little or no property recognize as inherently valuable. To do this, they might consider the idea of quasi-formal or quasi-legal businesses. This title applies to a firm that sells licit goods or provides licit services, in either case doing so without a license or adherence to pension, tax or social security regulations. This firm would be given a special license by the state at no cost, granting the firm owner and workers rights to a pension, social security protection, and training opportunities. In exchange for these benefits, the firm agrees to supply the state with information about its business, and to submit to regular monitoring by the state in order to determine changes in economic conditions or license requirements.

The concept of quasi-contract involves the perception of a contract even in the absence of a formal agreement. In this case, this is a preliminary arrangement between the informal firm and the state that is intended to protect the firm from the negative financial consequences of

373. PERRY, et al.

operating informally while illuminating a path toward voluntary formalization. In this sense, quasi-formal firms continue to operate within the informal framework but they do so with several key characteristics of formality that are mutually beneficial to the state and the firm.

These quasi-formal licenses would be distributed freely to any informal firm engaged in a minimal level of business, possibly excluding occasional work when it is combined with a full-time job in another firm. An eligible firm is one that sells licit goods or provides licit services, defined as such by the nature of the good or service rather than by its acquisition or delivery. This license can be granted in exchange for basic registration information about the firm, including owner name, type of goods or services provided, general location, and average earnings. No fees or taxes should be associated with this license and no retribution should be threatened based upon the information provided. The license will grant the firm access to the pension system, allowing their time as a firm operator to count toward the state's retirement and unemployment programs. The license will also grant the firm access to training through the local chambers of commerce or other entity, free or at low cost. Random surveys can be used to determine whether these firms remain in operation in order to terminate the license, and can help to determine the most appropriate training programs to provide.

The quasi-formal license is meant to protect informal firms by recognizing their contribution to the economy with pension and social security benefits, without interfering with their ability to operate competitively in the informal economy. They will be monitored by the state or a third party designated by the state in order to help the state maintain accurate and current statistical information on broader economic activity. Once the firm reaches a maximum income threshold, they will be required to register or risk losing their quasi-formal license. This will prevent would-be entrepreneurs from avoiding taxes by declaring themselves quasi-formal

firms. Once the state begins to acquire a more accurate picture of its informal economy and how it changes under different economic conditions, it can develop more appropriate social assistance programs and policies that generate demand for formality.

One obvious concern for a state in providing additional pensions without additional tax revenue is how to fund this endeavor. This approach is still intended to result in formalization of productive small firms, which will yield increased revenue for the state. However, as an incremental approach, the results will not be immediately apparent in state coffers.

Second, a fast-track judicial process for small firms, both formal and quasi-formal, should be designed by which these small businesses can seek formal judicial decisions and enforcement of these decisions in contract and property disputes, tort claims, and other non-criminal matters. Similar to a small claims court in the United States, this process would be intended to facilitate the efficient and inexpensive resolution of matters that do not merit lengthy and expensive traditional judicial process. Attorneys should not be required for these procedures, although they should be available at little or no cost to indigent defendants. Costs should be minimal for the parties, and decisions should carry the full enforcement authority of the state. This solution will encourage the use of formal court proceedings as opposed to or in conjunction with informal legal institutions, minimizing the possibility of corruption and violence and improving the attractiveness of participating in the formal legal framework.

Third, the state should develop training programs that focus on assisting informal micro-enterprises that may be inclined to enter into a social contract if they have the necessary means and knowledge of how to do so. This training might include how to establish and use a secure savings account, how to apply for small business grants, how to negotiate rental agreements, and how to use formal dispute resolution systems. The training should be offered at no cost and

should be provided in areas where a significant number of informal vendors work. Some informal firms evince a desire to move into something better, such as taking their street vending operation into a fixed storefront, but they have neither the financial means nor the knowledge of how to do so. This training delinks the formalization process from access to knowledge and allows the informal firm to learn about alternative paths to survival.

The first two recommendations here focus on the bulk of the informal economy – the non-entrepreneurs or the survivalists. The third recommendation is meant to capture the minority portion of the informal economy, consisting of the more entrepreneurial firms that are transitioning through the informal economy on the path to eventual self-formalization. A successful formalization program will apply solutions appropriate to both segments of the informal economy.

Reducing Health and Safety Risks

The informal economy is a risky place to do business. Entertainers juggle flaming batons as they stand on top of streetlights at busy intersections; peddlers walk the center line of highways and throughways selling books and DVDs to passing cars; street vendors with food carts lurch dangerously close to oncoming traffic on street corners; and day laborers toil in insecure environments for insecure wages. The health and safety of informal firm proprietors creates a significant liability for the state and can mean a heavy burden on state health services.

Some states have recognized the danger posed by informal vending by passing laws that force vendors to move from the streets and other public spaces to fixed shopping centers

provided by the state,³⁷⁴ or outlawing business transactions taking place at busy intersections.³⁷⁵

Yet these activities continue as informal firms realize that their flexible operation allows them to locate their business in the heart of the largest concentration of consumers, maximizing their profit potential. The rewards for some firms outweigh the risks.

Taking vendors off the streets or preventing them from earning sustainable profits through their activities can negatively impact their survival by reducing or even eliminating their earnings. However, state interest in public safety may outweigh private interests in conducting business in certain areas. While most countries already outlaw the provision of services or sale of goods on busy streets or at intersections, these laws are rarely enforced. The freedom to earn a sustainable income must be balanced with the risk to personal and third party health and safety resulting from the chosen type of economic activity.

In order to promote the safety of their citizens, while not substantially burdening informal business, states should expand the presence of law enforcement at dangerous intersections and facilitate the relocation of vendors, entertainers, and service providers in these places to safer locations on sidewalks and in shopping centers. In this case, the benefit of public safety will outweigh the interest in earning profits by engaging in business under unsafe conditions. However, this recommendation should be strictly limited to dangerous circumstances as defined by a reasonableness standard. States should not be permitted to abuse safety laws in the interest of cleaning-up public space or promoting the interests of formal business establishments opposed to informal business activity in their vicinity.

374. See MICHAEL G. DONOVAN, *Informal Cities and the Contestation of Public Space: The Case of Bogotá's Street Vendors, 1988-2003*, 45 *Urban Studies* (2008).

375. See, e.g., , *Conductores que Compren en los Semáforos Podrán ser Multados*, *El Tiempo* Nov. 26, 2008. 2008.

One alternative in the case where a state does not have the resources to provide law enforcement personnel at every intersection would be to provide street vendors with safety vests or to provide raised walkways along the road on which they can safely conduct their business. Poor urban planning in many developing countries leaves vendors with little choice but to walk down the middle of a busy road, or straddle an uneven or broken sidewalk to conduct business. Some small safety mechanisms could reduce the high number of vendor injuries and deaths as they attempt to earn a living by engaging in dangerous business activities.

Developing states with large and growing informal economies are in the midst of a dilemma. They want to eliminate or convert their informal firms in order to promote productive business development, investment, and economic growth, yet they lack the resources or willpower to force every informal firm to formalize or disappear, and they face a business community unwilling to bargain with them. Yet this dilemma is surmountable.

The informal economy will not disappear when a state offers a package of economic incentives to informal firms. Some firms may formalize to take advantage of these short-term benefits and then revert back to informality or close their business altogether when costs become too burdensome. Most informal firms have no interest in bargaining with a state that they distrust. They would rather operate outside the law and risk its inherent dangers than cede their freedom to a state oriented toward the protection of the propertied class.

But if the state perceives informal enterprise as what it commonly is – unskilled, unproductive, and often survivalist business – formalization becomes a social, rather than a legal process. Protection replaces prohibition; support replaces enforcement; and facilitation replaces elimination. States can play an important role in the success of existing and forming formal enterprises by engaging in the business development processes encouraged by

development institutions, while also playing an important role in the success of those firms operating informally by monitoring their progress, offering basic training opportunities, and maintaining an open door policy to the formal sector. This balanced approach may be the most effective way to curb the growth of informality by placing the tools and knowledge in the hands of those that will benefit most from it. And this, in turn, will improve the perception of the state as a party to the social contract.

Conclusion

Colombia's microenterprise promotion approach to formalization will likely succeed in facilitating the registration of some entrepreneurial small businesses. These businesses may have been informal in order to conserve capital in their initial stages of development, or to test out the market for their product or service before becoming official. Formalization programs may motivate them to formalize earlier than they had planned.

However, the impact of this approach on the growth of the informal economy is likely to be negligible. Until Colombia begins to focus on the cause of limited demand for legality, the informal economy will continue to flourish. The recommendations in the final chapter of this thesis should be carefully considered by the formalization committee in Colombia when setting policies for business development and economic growth.

As anyone who lives in a developing country will attest to, the informal economy is the lifeblood of domestic economic activity. It provides sustainable income for millions of workers, supplies formal firms and foreign investors with low cost inputs, such as labor and materials,

and disseminates raw capitalism to every doorstep, street corner, and park. The thought of a developing country without an informal economy is unfathomable.

Recognizing this fact, states can take action to facilitate a safer informal economy that places options in the hands of informal firms, allowing them to choose if and when they want to formalize, and giving them the tools to do so. For some firms, the informal economy is a place where they can earn enough basic income to eat for another day. For others, the informal economy provides the flexibility that they need to take care of their children or juggle multiple jobs. And for still others, the informal economy is a stage through which they are passing while they save enough income to form a formal enterprise. Yet all of these firms face the same daily challenges and need the support of the state.

Recognizing that informal firms do not significantly impact competition, foreign investment, or innovation, a state can begin to ease its enforcement efforts in favor of this enabling approach. The goal should not be the elimination of the informal sector, but rather the development of a harmless informal economy endowed with the tools needed to develop and potentially formalize independently.

Notable scholar Martha Chen was asked in an interview whether she thought that an informal economy would ever become too overwhelming for a state – whether there was a tipping point in its growth. She responded:

The informal economy is the dominant share of employment certainly in most developing countries. It is anywhere from 60-90 percent of total employment. It is not, however, often the dominant share of GDP or production. So there's a worry that the informal economy needs to become more productive. What I would say in terms of those who model what the economy should look like into the future is that I cannot envision an economy in countries like India – or even China or Ghana –where 90 percent of the workforce is informal that suddenly or even in the long term are going to become predominately formal. I think we have to accept that economies of the developing world, particularly, are hybrid.

We need to come up with models that allow the street trader to coexist along with retail shops and along with the large malls. But our models are tending towards encouraging the large retail and the malls and eliminating the street trader and I just don't think that this is tenable for these countries.³⁷⁶

Formalization advocates view the informal economy as an outlet for unproductive and illegal activity. They insist that without the legalization of these firms, the state will be held back in its economic development, foreign investors will flee and domestic enterprises will avoid innovation in the face of large informal economies. Accordingly, significant resources and time are invested in finding ways to incentivize informal firms to move into the formal economy.

For some, informality is a passage, and for others, it is a destination. But for all informal firms, the informal economy is a means of making the most of their skills given the existing level of demand and resources that they possess. There is little evidence that informal firms negatively impact economic growth; in fact, as argued previously, there is some evidence to support the idea that they facilitate growth by increasing competition, extending the life of products, and supplying formal firms with low cost labor and supplies.

Rule of law, which forms the basis of the state in most societies today, suggests that citizens relinquish certain freedoms in exchange for a promise by the state to protect their assets. And while it has been a success in many developed countries, where the majority of the population has assets worth protecting and where a culture of respect for the law is firmly established, rule of law has failed to achieve its goals in most developing countries. The informal economy, which consists largely of impoverished or lower-class citizens, owns few

376. MOLLY LANZAROTTA, Interview with Martha Chen, Lecturer in Public Policy, Harvard Kennedy School (2008).

assets worth protecting in exchange for the freedoms that they have in the informal economy.

As a result, most informal firms have chosen not to be a party to the state's social contract.

If states continue to treat informality as temporary, transitional, or illegal, they will face the very difficult, if not impossible, task of changing the culture of their economy. Resources would be better spent on anti-poverty programs, expanding access to pensions and unemployment insurance, and promoting the safety of informal firms and workers. By changing the relationship of the state to the informal economy, a new, more inclusive social contract can be negotiated. The state's role needs to shift from legalizing to enabling. They should capitalize on the dual legal and economic framework to promote the shared goal of effective economic development.

The informal economy is an integral part of a developing country's economy, and a crucial piece in its economic growth puzzle. Understanding how to capitalize on this vast economic resource and make it a safe and more secure option for unskilled and poor capitalists, will allow the state to have a meaningful impact on its bifurcated economy and to position itself as a worthy party to a new social contract.

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Kevin J. Fandl earned his Bachelor of Arts in Philosophy from Lock Haven University in 1998. He obtained a certificate in International Human Rights Law from Oxford University in 1999. He earned his Master of Arts in International Peace and Conflict Resolution from the American University School of International Service in 2000. He earned his Juris Doctorate in Law from the American University Washington College of Law in 2003. In law school, he served as the Senior Critical Essays Editor on the International Law Review. He is licensed to practice law in New York, Massachusetts, and Washington, D.C.

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Kevin was awarded a Dean's Fellowship from American University in the fields of International Trade Law and International Organizations. He was awarded a Presidential Management Fellowship in 2003, leading to an appointment with U.S. Customs and Border Protection. And he was awarded a Fulbright fellowship in 2006 to study and teach law at the Universidad de los Andes in Bogotá.

Kevin has given presentations about his research on law and the informal economy and economic development generally at conferences in India, South Africa, Colombia, and throughout the United States. He has been a keynote speaker and has served multiple times as a panel member at major international conferences.

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