

Informal Sector

Many citizens in emerging market democracies are excluded from participating in politics and the formal economy because poorly designed institutions prevent them from doing so. Policy reforms that reduce excess regulation and other barriers to entry can facilitate the migration of informal businesses to the formal sector, contributing to job growth, the tax base, and economic growth. In the process, these reforms create opportunities for the disenfranchised and generate a new constituency for democratic market systems. CIPE and its partners reduce informality by reforming business registration procedures and ensuring that private property rights are accessible to all citizens, clearly defined, and strongly enforced.

The world's awareness and understanding of informal sector issues have been powerfully shaped by Hernando de Soto and the Institute for Liberty and Democracy in Peru. De Soto demonstrated that the poor have productive assets on which they can build if their rights to property are formalized and defended. Venezuela's Center for the Dissemination of Economic Knowledge (CEDICE) examined the dynamics of street vending and worked with multiple stakeholders to find ways to move street vendors into formal commerce and economic activity. CEDICE's approach combined solid research with the engagement of informal sector associations.

Making the “Extralegal” Legal

by Nafisul Islam

In the early 1980s, Hernando de Soto, a successful businessman and economist, left Europe to visit his native Peru. During his trip, he was struck by the disparity between the vibrant entrepreneurial spirit of the people and their desperate poverty. To find the reason for this gap between motivation and result, he decided to open a small garment factory in Lima. His first step was to hire four university students who would complete the bureaucratic procedures necessary to obtain a business license. After 289 days and a cost 32 times the average monthly minimum wage, they received the license. This experiment convinced de Soto that it was expensive and time-consuming bureaucratic procedures that kept people out of formal markets and in the informal sector. To investigate this problem in more depth, and hoping to find a solution, de Soto founded a think tank, the Institute for Liberty and Democracy (ILD).

From 1981 to 1984, de Soto and his small research team at ILD talked to the poor in Peru’s shantytowns and compiled figures describing their businesses. The numbers confirmed a prevalence of economic informality in Peru. Fifty-six percent of all business, 86 percent of the bus service, and 60 percent of grocery retail in Peru were carried out in the “extralegal” sector. “Peru had become two nations – one where the legal system bestowed privileges on a select few, and another where the majority of the Peruvian people lived and worked outside the law, according to their own local arrangements.”¹

People conducted business outside the law because the bureaucratic regulations made it impossible to operate within it. As a result, they were denied opportunities to invest in businesses and participate in the formal economy. Even those people with thoughts of entrepreneurship could not trade beyond a circle of people who knew and trusted them.

De Soto came to realize that it was also the absence of formal property rights that explained why “people who have adopted every other Western invention, from the paper clip to the nuclear reactor, have not been able to produce sufficient capital to make their domestic capitalism work.”² He believed that people could be empowered by using their existing assets to benefit themselves and their communities. The poor of Peru possessed urban land and housing worth \$17 billion, but a majority of the people who possessed these assets did not have the legal titles to them. Consequently, people were not able to use their homes as collateral to obtain loans for business development. “Without a title, there is no way to build a system of securitization that gives them access to credit or water, telephones or electricity,” said de Soto.³ ILD estimated that in 1989 the poor in Peru held \$80 billion in untitled assets, assets that de Soto dubbed “dead capital” because they could not be invested to create new wealth.

“We put into place all the legislation and mechanisms required to bring into the law most extralegal real estate and business.”
-Hernando de Soto

Partnership for Advocacy and Legislative Reform

The first ever partnership of the Center for International Private Enterprise (CIPE), and one of its most successful, was with ILD. Beginning in 1984, CIPE helped ILD design an economic reform agenda and an advocacy campaign based on increased citizen participation in decision making. ILD used “289 days” – the time required to legally create a small business – as its slogan in order to convey the scope of the administrative barriers and legal discrimination experienced by small-scale entrepreneurs. Through advocacy and communications activities, ILD established working relations with many informal sector groups that became strong advocates for ILD’s legislative proposals. The research and proposals of ILD also found support among government officials who represented a broad range of political parties at the municipal and national levels.

In 1986 de Soto published *The Other Path: The Invisible Revolution in the Third World*, which offered the poor an alternative to revolution: entrepreneurship. The title of the book and its

policy prescriptions were a direct challenge to the vision of Peru's violent Shining Path insurgency. De Soto identified weak institutions as the primary barrier to entrepreneurial growth and highlighted the importance to development of institutions such as contract law, financial markets, and the judicial system. The book became a bestseller and was translated into twenty languages. The following year, de Soto introduced his ideas to multilateral organizations and reformers at the first international conference on the informal sector, organized by CIPE.

As part of its advocacy program, ILD drafted its own cost-benefit analyses of economic issues, which were published in various magazines with a combined readership of around 1.2 million Peruvians. These analyses covered topics such as access to credit, land titling, simplification of administrative procedures, and access to public information. The papers also included ILD's easily understandable proposals for legislative alternatives in these areas.

300,000 small enterprises were integrated into Peru's formal economy. The time needed to register a business was cut from about 300 days to less than one day.

ILD created an ombudsman's office, the *Balcon de Todos* (Balcony for All), in order to institutionalize direct access to lawmakers. The office received complaints, motions, and suggestions from citizens regarding the legal and bureaucratic problems they faced, and referred these to the attorney general's office. ILD researched the complaints, prepared economic and legal analyses, and proposed laws as solutions. This consultative program represented ILD's willingness to take initiative in setting a legislative agenda that would benefit a majority of Peru's citizens.

ILD was instrumental in drafting and advocating new legislation throughout the late 1980s. Peru's Administrative Simplification Law was approved by the Peruvian Congress in 1989 as a direct result of ILD's research and public advocacy efforts to simplify, reduce, and eliminate lengthy governmental bureaucratic procedures. ILD's recommendations that were included within the law ranged from reducing passport and

import registration fees to simplifying requirements for receiving retirement benefits. Another law drafted by ILD and enacted in 1988 was the Popular Mortgage Law. The law was designed to provide access to credit for informal landowners, who had previously received a mere 0.4 percent of the credit available from banks. The new law enabled Peruvians to obtain titles to their homes and thereby the ability to use their homes as collateral for a bank loan at market interest rates. Following the law's approval, ILD provided assistance to the government to ensure the proper administration of the law. ILD also helped draft regulations to be included in a new Property Rights Law, and created a property registry suited to the circumstances of landholders in shantytowns.

Success at Home for a Model Abroad

ILD has achieved tremendous results not only in Peru, but has also spurred reforms in countries as diverse as Brazil, China, and Thailand. Hernando de Soto has convinced numerous heads of state to implement institutional reforms, and many NGOs and think tanks have adopted ILD's approach to reform and advocacy.

As a result of ILD's domestic efforts, 300,000 small enterprises were integrated into Peru's formal economy, accounting for 560,000 legal jobs and contributing an added \$300 million in tax revenue. Moreover, the time needed to legally register a business was cut from about 300 days to less than one day. "After six years of listening to the poor, the ILD was actually in a position to help them," said de Soto. "We put into place all the legislation and mechanisms required to bring into the law most extralegal real estate and businesses."⁴

The activities described in this case study were funded by the National Endowment for Democracy.

Notes

¹ Jeremy Clift, "Hearing the Dogs Bark," *Finance & Development* 40:4, International Monetary Fund (Dec. 1, 2003).

² Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), p. 7.

³ “An Interview with Hernando de Soto,” *Economic Reform Today* 1 (1996).

⁴ Hernando de Soto, *The Other Path: The Economic Answer to Terrorism* (New York: Basic Books, 1989), xxvi.

Sources

“An Interview with Hernando de Soto.” *Economic Reform Today* 1 (1996).

Lawrence A. Chickering, et al., *Strategic Foreign Assistance: Civil Society in International Security*. (Stanford, CA: Hoover Institution Press, 2006), 29–39.

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Lowering Barriers to Participation in the Formal Economy

by Nafisul Islam

In recent decades, the percentage of Venezuela's workforce employed in the informal sector has been steadily growing, and by 2003 more people were employed in the informal sector than in the formal sector. This phenomenon – informality – can severely undermine a country's economic and political progress and stability through weak rule of law and ambiguous property rights. Informal entrepreneurs cannot access the benefits associated with formal businesses, such as bank credit and legal recognition of their businesses. Workers employed in the informal sector often find it difficult to break free from the cycle of poverty. They may be deprived from earning regular wages as well as other benefits of formal employment, such as social security.

In 2002, the Center for the Dissemination of Economic Knowledge (CEDICE), a Venezuelan public policy organization, recognized the toll informality had been taking on Venezuelans and decided to tackle the issue in depth. The organization looked at a broad spectrum of informal activities and chose to focus on the subgroup of business activity popularly referred to as “street vending.” In 2002, approximately five million individuals pursued informal activities in Venezuela, of whom approximately 30 percent were street vendors.

CEDICE benefited from the experience of the Center for International Private Enterprise (CIPE) in analyzing the nature of the informal sector and its effects, and was introduced by CIPE to the transaction cost economics of Douglass C. North and the Ronald Coase Institute. The model established by CIPE's Peruvian partner the Institute for Liberty and Democracy was especially useful for accurately framing the issues in Venezuela.

Defining Challenges to Formalization

CEDICE sought to examine some of the obstacles to doing business and how they related to the growth of the informal

sector. With CIPE's support, CEDICE conducted an empirical study of the informal sector in the Sabana Grande Boulevard zone in Caracas, Venezuela's capital. This area had become a focal point for informal sector activities and contributed to approximately 14 percent of informal commerce in Caracas. CEDICE spent more than a year collecting and analyzing an enormous amount of data.

The CEDICE study examined informality from an institutional perspective by focusing on access to credit, labor contracts, and access to retail space. A particularly important finding highlighted how the authorities responsible for managing public spaces had established an informal "market" for assigning spaces to vendors. This constituted a major section of transaction costs for informal entrepreneurs.

Based on the Sabana Grande survey, CEDICE undertook another extensive project analyzing the informal chain of textile production in Venezuela. The research covered the production, distribution, and sale of textile products, and included a survey that was administered to 376 street vendors of textiles in the Metropolitan Area of Caracas. The CEDICE team met with businesspeople in the textile sector to first understand and then map out how the formal and informal sectors intersect. As a final product of this investigation, the team developed the first ever database of informal workers in Venezuela. These were the first studies to provide such an in-depth quantitative and qualitative analysis of Venezuela's informal sector, and they became powerful tools in informing public policy design and promoting mass media awareness.

CEDICE facilitated consensus on a framework for revitalizing public spaces used for informal commerce. Nearly everyone – from political leaders and entrepreneurs to civil society groups and informal workers – was made aware of the high cost of informality.

Turning Analysis into Results

CEDICE used the information gathered from its research and its involvement in various forums and conferences on informality

to develop a public policy agenda. The policy recommendations were compiled in a publication series, “Informal Economy in Venezuela,” and distributed to local, regional, and national policymakers; senior business leaders; and other civil society groups.

The study focused on the growth of street vending not as an isolated phenomenon but as a consequence of a series of economic failings, including mass unemployment, restrictions on private entrepreneurship, and, most importantly, the high cost of doing business. According to the study, the main challenge for public policymakers was to change the incentive system, making it easier to formalize informal business activities. Therefore, a primary policy recommendation was to formalize the informal property rights of street vendors. The long-term strategy described in the policy recommendation was designed to make it less lucrative to do business as a street vendor in order to promote other economic activity. This meant helping street vendors pursue options in which they could receive higher returns for their investments of time and money. Alternatives to informal commerce – mainstreaming informal businesses and increasing opportunities for formal employment – were also discussed in the study.

Another long-term measure to change the incentives structure was to lower the cost of doing business in the formal sector. Among the strategies were lowering business registration costs, easing access to credit, and assisting in compliance with labor regulations. For example, 62 percent of all credit in Venezuela was based on informal networks. Enhancing private formal micro-lending would reduce the dependence on informal lenders and would make the transition to formal business participation an easier process. Venezuela also had the most costly labor regulation in Latin America, which made the cost of hiring contract workers too high for most businesses. A revision in the Venezuelan Labor Law could ease some of these regulations and provide incentives for enterprises to hire more workers.

Fostering Informal-Public Sector Dialogue

The studies also allowed CEDICE to establish connections with informal sector associations at the grassroots level. For example, CEDICE used its contacts to assist in the formation of a working group comprising local government policymakers, representatives from formal and informal business groups, and other civil society organizations. Through weekly roundtables, members of the working group addressed urgent needs and the long-term problems posed by informality. This was the first series of policy dialogues between informal sector associations and local authorities in Venezuela. Despite political and ideological differences, CEDICE successfully facilitated the dialogues, which culminated in a public policy agreement subscribed to by the members of the group. The group reached a consensus on a framework for public policy interventions designed to reorganize and revitalize public spaces used for informal commerce. The agreed framework, modeled after the Sabana Grande study, contained policy recommendations for service provision, sanitation, security, and zoning regulations.

CEDICE had a strong impact on revitalizing the subject of informality as a national policy priority and in suggesting sound public policies to curb informality. Due in large part to CEDICE's work in this area, nearly everyone – from political leaders and entrepreneurs to civil society groups and informal workers – was made aware of the high cost of informality. One of CEDICE's most valuable contributions was its success in bringing different stakeholders into meaningful dialogue, and in helping these diverse groups think about the problems and agree on possible solutions.

The activities described in this case study were funded by the National Endowment for Democracy.

Source

Wladimir Zanoni López, "Street Vendors in Caracas: An Exploratory Study and Public Policy Proposals," Center for the Dissemination of Economic Knowledge, Informal Economy Studies and Public Policies Unit (2005).