

# **INFORMALITY: EXCLUSION AND PRECARIOUSNESS**

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## **A. Introduction**

During three decades and a half informality has been in the scenario of debate. From conceptual differences to political discrepancies contributed to keep alive this contribution of the ILO to the employment and poverty debate. From academicians, it moved to practitioners and international agencies, including lately an emerging interest of social and labor organizations. Two factors probably helped in this lasting interest on informality. First, the strong link between informality and poverty and underemployment, as well as, the important absorption of the most vulnerable groups in society, particularly, women and young people. Second, the capacity of adaptation of the concept to the emerging factors derived from economic and social changes in the world and to the results of the permanent discussion. This can also be read as one of the main liabilities of the concept, since prescriptions tend to be diverse and changing through time, but the main guidelines for the core policy prescriptions have remained there.

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

The objective of this paper is limited. It starts by shortly reviewing the evolution of the concept of informality and in particular, the transit from the informal sector to the informal economy. In the second section, on the basis of the data available, the size, characteristics and evolution of the informal economy in Latin America is analyzed. The third section, the main part of the report, contains a strategy for inclusion and opportunities of those working in the informal economy. This strategy is focused on the regulatory framework affecting both employers and workers in the informal economy. The paper ends with a brief section on the strategy and the cultural change required to be successful.

## **B. Informality: from sector to economy**

The notion of the informal sector was brought forward to the international scenario by the ILO in 1972 in an employment report on Kenya<sup>1</sup>. The main contribution was to highlight that the problem of employment in less developed country is not one of unemployment but rather of employed people who do not earn enough money to make a living. They are “working poor” and economic informality was defined “as a way of doing things”. They work in small units, produce or sell goods and services, and also employ members of the

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<sup>1</sup> The mission directors were Richard Jolly and Hans Singer, both from the IDS at the University of Sussex. A previous paper was written by K. Hart, although published in 1973.

family and eventually, wage-workers. Concentrated in urban areas and use little capital, while the division of labor is small. The key conditions were easy of entry and the operation in unregulated or competitive markets. The outcome was low productivity and a reduced potential for growth. As a result, incomes are low and they constitute most of the poor population. Their conceptual interpretation was made in opposition to formality and on the basis of their lack of access to markets and productive resources.

The conceptualization was based on a logic of survival, since employment created in the formal sector was not enough to absorb the increasing population and the only option available was to create their own jobs under conditions of lack of access to resource and markets<sup>2</sup>. The logic of survival was not equivalent to a dualistic approach since early in the 1970's it was recognized that informality was connected to the rest of the economy while the issue was to determine the nature of those interrelationships (Tokman, 1976 and 1978). The main question was not whether the informal sector would grow since that was clear, given the rapidly growing labor force and the insufficient creation of new jobs; but rather whether the expansion would be accompanied by higher or lower average incomes for those occupied in the sector.

As all new concepts the informal sector definition was questioned by many authors, inside and outside the ILO, on the basis that the informals constituted a workers reserve functional to the accumulation process of modern enterprises, since they were many and available as needed at lower wage levels (Gerry, 1974; Bromley, 1978). Linkages were recognized and subcontracting relations were identified, although more intensive in countries at a more advanced stage of industrialization<sup>3</sup>. A more recent conceptual development was linked to the increasing productive decentralization associated with globalization and changes in technology that made it possible<sup>4</sup>. To deal with an increasing demand, modern enterprises adapt to the new environment by introducing more flexible productive systems and decentralizing production and labor processes, which reduce costs, externalize demand fluctuations and weaken the bargaining power of unions. The typical employment relationship between an employer and his workers within an enterprise was partly displaced by another employment relationship, not always visible or clearly defined, that could also mean multi-firms involvement. Hence, obligations and responsibilities became diffused resulting in higher flexibility and lower labor costs but for the workers it meant reduced wages and lost of protection.

Another research effort emerged allocating a growing importance to the informal sector's operation beyond the prevailing legal and institutional frameworks<sup>5</sup>. This coincided with the reform period guided by the Washington Consensus, which emphasized the need to liberalize the economy and to diminish government intervention and particularly,

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<sup>2</sup> In Latin America this perspective was further developed (Tokman, 1995) introducing informality within the employment analysis in a structural framework as developed by Prebisch (1970) and Pinto (1965), among others.

<sup>3</sup> Lubell, (1991) arrives to this conclusion based on the research undertaken under the World Employment Programme of the ILO in Africa, Asia and Latin America. His survey reviewing studies and policies undertaken at the OECD Development Center constitutes an important contribution.

<sup>4</sup> Portes, Castells and Benton (1989).

<sup>5</sup> De Soto, (1986). Perry, G et al. (2007).

regulations and bureaucracy. Heavy regulations and inefficient processing introduce barriers for business development and in the case of the micro-enterprises, force them to operate informally. As argued by De Soto, inadequate regulations, designed for formal enterprises affect the legal recognition of the assets of the poor and result in exclusion from property, while “paper walls” and long processing times conspire against formalization. Furthermore, according to a recent interpretation by the World Bank, this means exit rather than exclusion, since the informals “voluntary” avoid formality given the existing barriers. On this issue, we will come back in the next section.

Thirty years later the ILO introduced the informal sector expanding the concept from the sector to the economy. The informal economy was defined as “*all economic activities by workers and economic units that are- in law or in practice- not covered or insufficiently covered by formal arrangements*”<sup>6</sup>. It includes both, enterprise and work relationships, and it does not eliminate the informal sector but expanded it to include all workers that are not sufficiently covered even if they are employed in formal units of production. It provides a framework to capture the spurious decentralization that is associated to externalization or even subcontracting inside formal units of production.

Beyond the debates and different analytical perspectives that have prevailed during the last 35 years the concept (s) of informality has contributed to the understanding of employment and development problems and to identify strategies and clarify priorities. The debate will surely continue but it is an adequate time to capture the milestones of an evolving concept. It started as an issue related to urban problems and urban planning and it was upgraded by the World Employment Programme of the ILO by placing it in the context of employment, poverty and development in developing economies around the world. In the 70’s and up to the mid 80’s, informality was crucial to understand the employment problem in developing countries and to learn why it adopted less visible forms and particularly, why growth was not ensuring a convergence path to the situation prevailing in developed countries. The informal sector debate served to advance the understanding of the dynamics of growth and employment creation from multiple perspectives, capturing the most relevant structural features of underdevelopment and particularly, the determinants of poverty and the mechanisms of survival that the people were forced to create.

From the mid 80’s and particularly, during the 90’s the world economy registered fundamental changes that instead of shifting the debate away from informality it introduced new perspectives on a concept that by then was beyond the academic discussion and was becoming an accepted political and policy instrument. Globalization and technological change affected the growth model of developing countries. They also had to confront the deep crisis caused by the rise of oil prices in the 70’s, but especially, in the 80’s a crisis caused by the heavy indebtedness incurred and facilitated by the high liquidity of the international monetary system. The change of the growth model was reinforced by a macro-economic crisis, particularly in Latin America. Economic reforms were introduced during the 80’s and the labor reforms searching for flexibility were

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<sup>6</sup> ILO, (2002)

introduced, while decentralization of production and labor was promoted to improve the competitiveness capacity.

As a result protection in the formal sector was eroded and jobs became more unstable. This was increasingly visible affecting not only the structurally excluded in the informal sector, but also those working in small and medium size enterprises participating in decentralized production chains becoming more vulnerable to economic fluctuations and emerging risks, while the expected upward mobility to more stable and protected jobs weakened. The recognition of the workers in this situation as informal but beyond the sector was captured by expanding the definition of informality to the economy.

## **B. The informal economy: some facts for Latin America**

The size of informality can be estimated, following the definition adopted for the informal economy. In this section an attempt will be made on the basis of household surveys for sixteen countries of Latin America<sup>7</sup>. First, the size of the informal economy will be measured by adding unprotected waged employees in establishments of more than 5 employees to the informal sector, both restricted to urban areas because of the constraints on data availability. The evolution for the last fifteen years will be included, as well as the structure of the informal economy explained by two main components: exclusion and precariousness. The data will be aggregate for the region as whole, but some indications on country variations are included to highlight the prevailing heterogeneity. Second, the structure of the informal sector will be analyzed and in particular, differences in incomes within the sector will be used to examine exclusion and voluntary decisions (or exit) hypothesis. Finally, as unprotected workers in formal units of production closely relate to the structure of labor contracts and the differences between contracts, this will be also examined.

### ***1. Size, Structure and evolution of the informal economy.***

The informal economy in Latin America concentrated 64.1 per cent of non-agricultural employment in 2005. 50.3 percent were in the informal sector, while around 13.8 percent were unprotected workers in formal establishments. Seventy eight percent of the informal economy is in the informal sector, being the most significant component, but 22 percent is constituted by informal workers employed in the formal sector. The informal economy

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<sup>7</sup> The data source is CEPAL on the basis of national households' surveys including Argentina, Brazil, Chile, Costa Rica, Ecuador, Nicaragua, El Salvador, Guatemala, Mexico, Panama, Paraguay, Peru, Dominican Republic, Uruguay and Venezuela. As the relevant questions are not included until recent years the number of countries included will be added to each table.

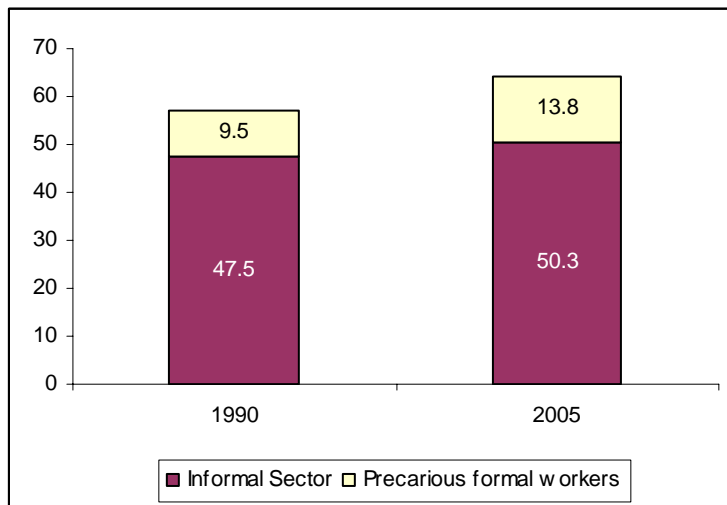
expanded from 57 to 64,1 percent of urban employment between 1990 and 2005; while both the informal sector and precarious workers expanded, the latter grew faster (table 1 and graph 1). This is closely connected to the increased precariousness during the reform period in Latin America. Close to 60 percent of the expansion of the informal economy is explained by this reason.

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

	1990	2005
Informal Economy	57.0	64.1
Informal Sector	47.5	50.3
Precarious formal workers	9.5	13.8

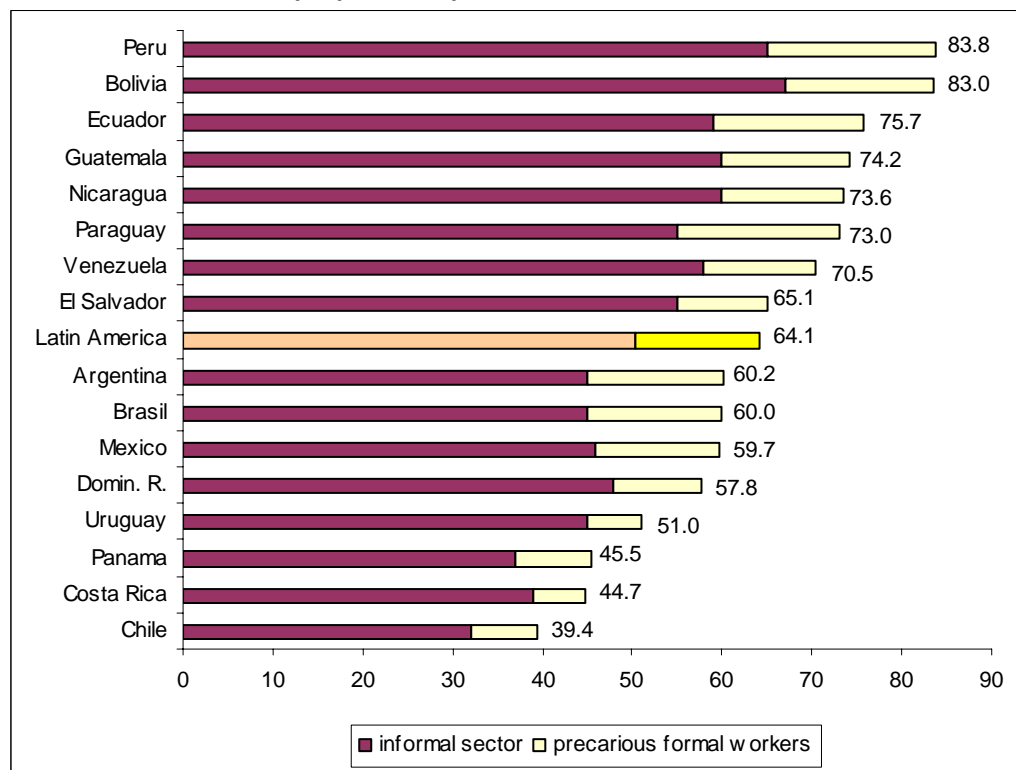
*Sources and notes: ECLAC on the basis of households' surveys and Tokman, 2007. It includes 16 countries in 2005 and in 1990 for the informal sector. Precarious formal workers in 1990, refers to 5 countries. The percentage for 2005 does not significantly differ for 5 or 16 countries. It refers to the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

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



The situation varies according to countries from a country like Chile, that register around 39 percent of urban employment in the informal economy, to Bolivia and Peru, where the percentage is close to 84 percent. Three groups of countries can be distinguished. First, most of the Andean and central American countries with between 70 and 84 percent in the informal economy (Bolivia, Peru, Ecuador, Nicaragua and Guatemala). A second group at the other extreme integrated by Chile, Costa Rica and Panama with an informal economy that concentrates between 40 to 50 percent and a third intermediate group of countries ranging from Uruguay with 51 percent to El Salvador with 65 percent and including also Argentina, Brazil, Mexico, El Salvador and Dominican Republic (graph 2).

**Graph 2**  
**The informal economy by country, 2005**



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

In 2005, 50.3 percent of non-agricultural workers in Latin America were employed in the informal sector. More than half among them (55%) were own-account workers, one third worked in micro-enterprises of less than five employees and around 12 percent were domestic workers. It grew from 47.5 percent in 1990 to the present level and it also differs among countries with a similar pattern shown by the informal economy. While the Central American and Andean countries register the larger size, Chile, Costa Rica and Panama are at the lower end, but also joined by Mexico, Brazil and Uruguay. As compared to the size of the informal economy observed, particularly for the last three countries denoting the importance of informality in formal establishments. Only Chile Argentina, Brazil and El Salvador have registered a decrease in the size of the informal sector. The higher the per capita income, the smaller the informal sector; and the larger informality is, the greater perception of insecurity. Sixty five of the poorest 40 percent of the population and 74 percent of those in poorest 10 percent work in the informal sector (Tokman, 2007).

## **2. Exit or Exclusion. Income Differentials in the Informal Sector**

The income gap between formal sector workers and those in the informal sector increased from 59 to 81 percent during the last fifteen years. The same is registered for wage workers according to the size of the establishment. Those working in formal

establishments increased their gap with those working in micro-enterprises from 46 to 81 percent during the same period. As expected, the income gap between employers and employees is larger in enterprises of more than 5 workers than in micro-enterprises. Both gaps, however, decreased in particular because of the reduction in the former.

**Table 3**  
**Income differentials by sector and occupational category in Latin America (1990 a 2005)**

	1990	2005
Formal sector employees / informal sector employees	1.59	1.81
Wage employee in firm > 5 / Wage employee in firm <= 5	1.46	1.81
Independent worker / Private wage employee	1.04	0.79
Independent worker / Wage employee in firm <= 5	1.51	1.24
Employers in firms > 5 / Wage employee in firm > 5	6.31	4.66
Employers in firms <= 5 / Wage employee in firm <= 5	4.52	3.82

*Note: The figures are ratios between the labor incomes in the selected categories for the respected years.  
Source: Based on ECLAC data from households surveys of 15 countries..*

It is also noteworthy the evolution of gaps between employees and own-account workers, since this can be occupations voluntary occupied after evaluating the costs and benefits involved. As argued by the World Bank (2007), the decision to opt for these jobs responds to the higher cost involved for operating in the formal sector and the greater independence and flexibility associated to them. The person opting for these jobs is exercising a right to opt out. Exit rather than exclusion is the suggested denomination of such a decision. Indeed, entry barriers may push out some of the people in the informal sector as well as independency and flexibility constitute additional incentives for this decision providing an occupational solution to the individual, but also to the family.

However, there is also need to look at earnings produced under different ways of insertion. The income gap between an own-account worker and a wage employee in a micro-enterprise was at 50 percent in 1990 and there were no significant differences if compared to workers in formal establishments. It would be a rational decision to prefer an own-account occupation. However, both gaps decreased afterwards reaching by 2005, 24 percent as compared to a worker in a micro-enterprise and became negative in relation to a worker in a formal establishment. If the only choice is to remain in the informal sector, the incentive to work on her/his own account is clear, although becoming less attractive. However, the comparison should be made either in relation to the worker in larger establishment, in which case if those jobs were available they were a better option in terms of earnings, or, even more likely, an own-account worker pattern of mobility would be on the employers track becoming either an employer in micro-enterprises or in a formal establishment. The first option suggests that jobs in the formal sector as workers were not available and the second requires being able to pass entry barriers. Hence, most



of them will be there as a result of lack of better opportunities, rather than as a voluntary decision to escape formality.

### ***3. Informality, Labor Contracts and Social Protection***

Access to protection requires a formally recognized employment relation. This is acquired through a written labor contract. Without it, a worker is not recognized. In 2005 on average in Latin America 37.7 percent of the wage workers are employed without contract, a percentage that is concentrated in the informal since it affects to 68 percent of the workers in the sector, but also to 26 percent of the workers in formal establishments (see graph 3 and 4, first row). However, according to the scarce data available, this has not improved, instead there has been an increase in the percentage of workers without contracts or without full protection of around 4 percentage points, entirely explained by the workers under this situation working in formal establishments but included in the informal economy. Data available for Peru, Argentina and Chile, show a significant increase in the percentage of wage workers employed without contracts or under fixed term contracts during the 1990's (Tokman, 2006). According to household surveys around the year 2000 this trend continued and the percentage reached 74 percent in Peru and 35, 8 percent in Argentina. A study of un-registered private employment in Argentina showed that in 1990, 29.6 percent were in that condition, increasing to reach a maximum of 43.4 percent in 2004 and later decreasing to 39.8 percent in 2005<sup>8</sup>.

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

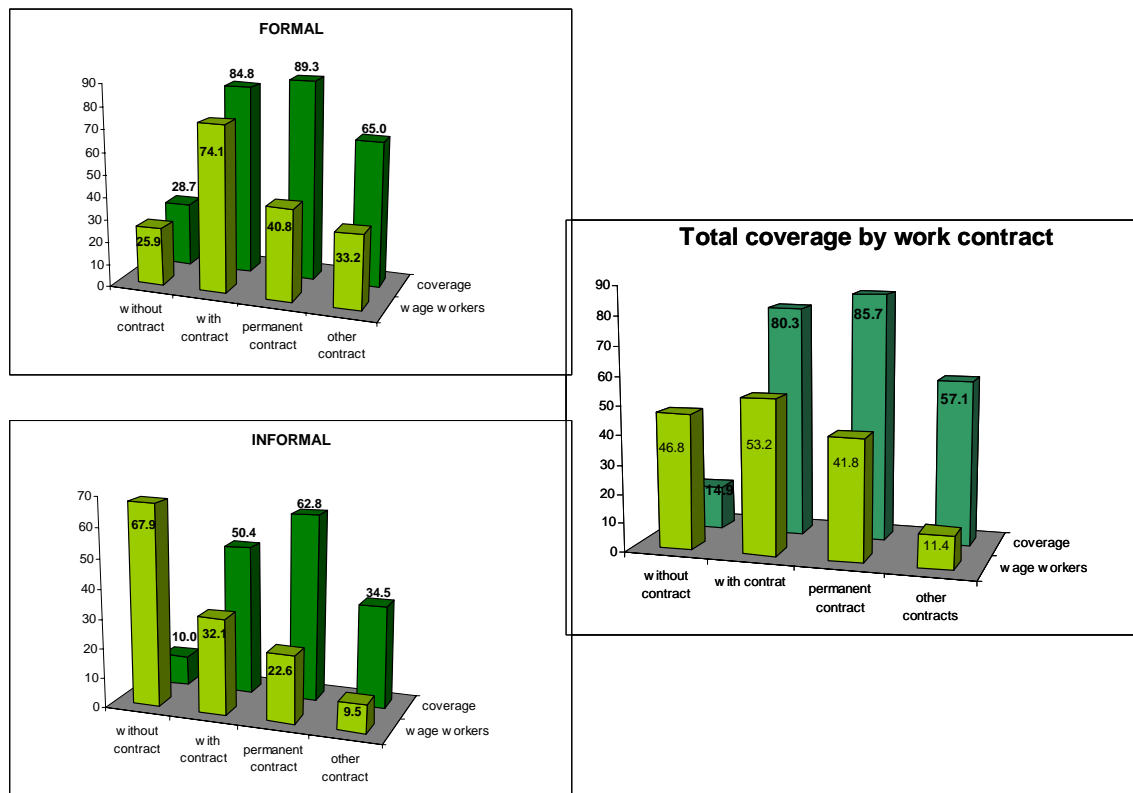
Differences in social protection coverage for those workers with or without written contracts are substantial, independently of whether they are employed in the informal or in the formal sector<sup>9</sup>. On average, 19 percent of the workers without contracts have access to social protection, while the probability of access to protection is more than four times higher for workers with contracts. The probability of being protected in the case of workers without contracts in the informal sector is 10 per cent, while the gap with workers with contracts in the same sectors is 5 times. Working without contract in the formal sector has a probability of 29 percent of being protected and the gap with a worker with contract in the same sector is almost three times higher (see graph 3 and 4, second row).

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<sup>8</sup> The data refers to Gran Buenos Aires for the period may 1990 to the fourth trimester of 2005. Ministerio de Trabajo, Empleo y Seguridad Social, 2006.

<sup>9</sup> Social protection is measured as proxy by the percentage of workers in each type of contractual situation that contributes to old age pensions.

**Graph 3**  
**Social protection coverage by contractual situation**



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

The type of contract also matters to determine access to social protection. The permanent contract, covering around 70 per cent of the workers with contracts, ensures a very high probability of being covered by social protection. Near 86 per cent of the workers under these contracts, are likely to benefit from social protection. Access to social protection reaches to 89 per cent of the workers with permanent contracts in the formal sector, while the percentage is 63 for those under similar contracts in the informal sector. Working under atypical labor contracts result in a loss of protection since only the 61 percent of the workers on average have access. Sixteen percent of the wage workers and around 30 percent of those with contracts are in this situation. Both the probability of coverage and the percentage of wage workers under atypical contracts are higher in the formal than in the informal sector. One third of the workers in the former are employed with atypical contracts and 65 percent among them have access to social protection; in the informal sector less than 10 percent of the workers possess this type of contracts and the probability of being protected is 34 percent.

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

### **C. Towards a Strategy for inclusion and opportunities**

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

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

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

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

#### ***1) Regulation of informal activities***

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

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

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

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

The separation of assets between the individual and the entrepreneur (also a very important step to micro-entrepreneurs), is usually conducted by creating firms of a diverse legal nature and diverse degrees of complexity. Requirements associated with this simple but crucial change to the patrimonial responsibility of micro-entrepreneurs, entail a monetary cost, as well as compliance with a series of regulations that render this

enfranchising step towards formality a difficult one. This process could be simplified by conferring legal status to the entrepreneur along with the business license<sup>10</sup>.

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

## ***2) Labor rights in informal enterprises***

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

The share of workers without a contract or on atypical contracts is over 90 per cent in Bolivia and Guatemala, and reaches about 85 per cent in Mexico and Ecuador. Pension's coverage extends to only 18 per cent of those occupied in the informal sector, compared with 68 percent in the formal sector (Tokman, 2006). This difference is partly explained by the poor pension coverage of own account workers. Although the difference between wage-employees is smaller, the coverage of those in micro-enterprises is still one third of those in larger enterprises (CEPAL, 2007). Most workers in the informal sector are not entitled to employment protection because their employment relationship is not legally recognized. On average for Latin America, 78 per cent of wage workers in micro enterprises do not have a written labor contract<sup>11</sup>.

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

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<sup>10</sup> Fuentes, (1998).

<sup>11</sup> It includes 11 countries. In 6 of them this percentage is higher than 90 percent (CEPAL, 2007).

Recognition of the employment relationship would contribute to improve labor and social protection. This could be achieved with proof of the existence of unwritten contracts by registration of regular hours and periodic wage payments in the accounts or by witnesses. This would provide the workers with the necessary credentials to be entitled to protection and would encourage micro-entrepreneurs to acquire the necessary skills to do business on a proper basis. Recognizing the existence of a formal employment relationship generates the pressure needed to manage the production unit according to proper business and not as a family enterprise.

This first step will, however, not be sufficient because of the enterprises' inability to absorb the costs of compliance. Some adjustment to the existing legislation may be necessary to make it more applicable, but this should not be with deregulation, as being more responsive to the need of micro-enterprises does not mean that existing labor conditions can be allowed to deteriorate.

Alternatives, systems especially designed for the informal sector could be introduced. This would imply dual or preferential systems, as practiced in various countries, such as Argentina, Brazil and Peru. Such differentiation may prove difficult to implement for regulatory inefficiency and as a matter of principle: it creates opportunities for fiscal and labor law evasion and creates barriers to micro-enterprise growth by setting maximum limits on capital investment. In the area of labor law, such differentiation introduces issues of principles because it accepts differential treatment of workers before the law, depending on the size of the enterprise employing them. For this reason, a single regulatory system is preferable as regards to labor aspects (ILO, 1991). Of course, this does not exclude differential treatment for other related matter, such as the introduction of simplified taxation systems or preferential rates for credit. Even on labor issues, there is a tendency to consider special regimes for collective bargaining responding to the needs of small units of production.

The reality should be recognized, but this does not necessarily mean refraining from intervening. A possible approach should be to introduce a compulsory minimum threshold on labor issues. An initial component should consist of fundamental labor rights such as those included in the ILO Declaration of 1998 (freedom of association and collective bargaining, elimination of force and child labor and discrimination in respect to employment and occupation). This amounts to human rights transferred into the labor sphere. In addition, related aspects of working conditions could also be included, as for example: minimum wage, hours of work and work-related accidents and illnesses<sup>12</sup>.

This minimum floor should be enforced for all workers in the informal sector independently of the size or form of the unit in which they work. This is not at odds with the notion of operating with a tolerance margin, which allows for the constraints encountered by informal sector production units. This tolerance could be acceptable but should not be applied to fundamental rights or the suggested minimum floor. The

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<sup>12</sup> This broader minimum threshold has been incorporated into the free trade agreements signed by the United States and various countries, including Mexico, Chile, all the countries of Central America and Dominican Republic, Panama, Peru and Colombia (the latter two still pending of definitive adoption).

application of these rights should be monitored, promoted and controlled using procedures that take full account of the specific nature of each issue being regulated.

One possible model would be to establish an advance commitment to compliance, with fix objectives similar to those used by the ILO to supervise international labor standards. Another would be to recognize that some non-compliance are due to ignorance of the legal obligation involved. The labor inspection should include a learning component, or as Chile has done since 2001, should substitute the fine with training for informal sector entrepreneurs under the supervision of the relevant labor institution. The ILO has also proposed an innovatory approach to monitoring compliance with labor legislation by micro- and small enterprises (2006). This is based on the assumption that the effect of regulation is enhanced if there are several possible ways of enforcing compliance, allowing the problems to be monitored and solved in a gradual way.

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

### ***3) Insecurity, vulnerability and atypical employment contracts***

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

Both have increased in recent decades to adapt to the new economic conditions under globalization. Decentralization of production and labor processes emerged as an instrument to decrease costs and particularly, labor costs, as well as to increase efficiency given the availability of new technology and the explosive introduction of information technology. This happened both within and between countries as illustrated by the expansion of multinational investment flows worldwide. This contributed to a spurious decentralization to erode compliance with labor regulations or even, diluting the employment relation definition. At the same time, there was need to adapt to a more open and volatile international economic environment. Adjustments were needed and the search of flexibility to diminish the costs involved became a priority. In particular, reforms were introduced in the labor markets to facilitate and reduce the costs of firing and hiring new workers.

The labor reforms in Latin America introduced alternative contracts to the permanent employment with this objective. A strategy of “flexibilization at the margin” was followed by introducing atypical contracts for new hiring’s and reducing the cost of

dismissals. Employment relationships without contracts are concentrated in the informal sector, while those atypical contracts tend to concentrate in formal enterprises and even in the public sector. However, given that they associate to insecurity and they are considered as a natural part of the informal economy. In general, they do not affect social protection as long as workers remain employed; nor are they illegal, as they were introduced by labor reforms which encouraged their use.

In Argentina and Peru (both countries have implemented comprehensive labor reforms) there are no significant differences in non-wage labor costs among contracts. This indicates that if labor regulations are complied with, labor and social protection are broadly similar. The main exception is unregistered workers without any form of contract. In the case of Argentina, exceptionally promotional temporary contracts were introduced in 1995 but abolished three years later, including a subsidy to reduce the employer contributions and a low or zero contract termination cost (Chacaltana, 2005).

Although the new forms of contract may have entailed some loss of protection, their chief effect has been insecurity about the continuity of the current contract. This insecurity affects the worker and the family as well as productivity, because of the loss of incentives to innovate and to upgrade skills. For this reason, while recognizing that these contracts are necessary and particularly, to promote employment for women and the youth, limits on their use should be introduced and efforts should focus on ways of making long-term contracts more flexible. That is, in fact, what happened.

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

Both countries however, changed the orientation of their reforms since the mid 1990's. Spain restricted the use of fixed term contracts to collective bargaining and transferred the search of flexibility to the permanent contract facilitating the judicial process of firing and reducing the costs involved. This reform was introduced as a result of a Tripartite Agreement. A new Agreement was reached in 2006 reinforcing the new orientation promoting the return to the permanent contract by converting fixed term contracts into a permanent after 24 months of a contract with the same enterprise or successive contracts in the same post. It introduced additionally a 4 years bonus for long term contracts given to women, young people and long duration unemployed and reduced contributions to social security. Argentina followed the same path in the reforms of 1998 and 2000 constraining the use of fixed term contracts, reducing indemnities in permanent contracts



and extending the trial periods. In addition, contributions to social security were reduced in contracts for workers older than 45 years, younger than 24 years and women head of households. In its reform of 1998, Brazil also introduced atypical contracts but made them conditional upon the creation of new jobs in order to reduce the potential contract substitution and left it up to collective bargaining to set upper limits on the number of contracts to be concluded.

#### ***4) Ill-defined employment relationships and their regulation***

Another issue is ill-defined employment relationships that are difficult to establish clearly or are disguised or unprotected owing to gaps in the labor regulation or compliance control. The rights and obligations of both parties are often not clear, which may result in loss of protection due to workers. Such cases are growing in number in the context of globalization and decentralization of production, which make it necessary to establish workers rights and to determine who the responsible employer is. Most of the enterprises involved in these relations are formal, but the workers rights in subordinated firms are not necessarily fully complied. They are part of the informal economy. These hidden or ill-defined relations also exist between formal and informal units introducing additional difficulties in its identification.

The ILO began to study the question in 1998 and the Employment Relationship Recommendation of 2006 (No 198) was adopted. Countries are recommended to “formulate and apply a national policy for reviewing at appropriate intervals and, if necessary, clarifying and adapting the scope of relevant laws and regulations, in order to guarantee effective protection for workers who perform work in the context of an employment relationship”. The nature and extent of protection should be defined by national law or practice, or both and should include scope, coverage and responsibility for implementation.

It is also recommended that national policy should provide guidance for the effective determination of the existence of an employment relationship and on the distinction between employed (subordinate) and self-employed (own account) workers. In doing so, it is important to use very clear methods of determining the existence of such relationships (so that they cannot remain disguised), and do so without prejudice to how the relationship is characterized in any arrangement or contract that may have been agreed between the parties. To help determine this, indicators suggested, other than the regular payment to the worker, include: that the work is carried out according to the instructions and under the control of another party; whether it is performed solely for the benefit of another person; whether it must be carried personally by the worker, within specific working hours; and whether it required the worker’s availability and involves the provision of tools and machinery by the party requesting the work. The Recommendation also suggests that national policies should include measures to combat disguised employment relationships. It should also uphold standards applicable to all forms of contractual arrangements, including those involving multiple parties and ensure that such standards establish who is responsible for the protection contained herein.

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

In this connection, mention may be made of the adoption of a law of subcontracting in Chile where 50 per cent of the enterprises were estimated to contract out part of their production and 20.7 percent to subcontract their main economic activity in 2004. Moreover, one third of the labor was estimated not to have a direct contractual link with their employing enterprise, but to be providing services via subcontractors or through agencies supplying temporary staff.

The law sets limits only on the supply of staff for short term jobs and exceptional tasks. In order to comply with labor law obligations, it requires enterprises to register and establish a guarantee fund to meet wage costs and contributions in case of non-compliance. Regarding the subcontracted the responsibility lies with the subcontractor, but the law also places responsibilities on the main contractor. The law changes the existing subsidiary responsibility of the main contractor into a jointly responsible compliance with these obligations. However, the main enterprise may exercise its right to require certification of compliance by the subcontractor and may withhold from pending payments any amounts due in case of non-compliance. While recognizing that this subcontracting model has the advantage of being more flexible, the law requires a proof of compliance from the enforcement authority involved and makes the main enterprise an indirect agent of control to ensure that the subcontractor complies with his obligations under labor law.

##### ***5) Social protection for informal workers***

Coverage extension of social protection (health and pensions, as well as maternity) for informal workers requires a strategy that considers different options, from expanding coverage of existing systems to the development of new mechanisms by the excluded through pooling of resources or insurances. All alternatives can be considered, while examples of different schemes for the provision of protection need to be evaluated. India recently introduced a bill to regulate employment and service conditions of unorganized workers and to provide for their safety, social security, health and welfare and introduced

a Welfare Fund financed by government and registered employers with this purpose. In the Philippines the Statutory Social Security system and the health insurance plans have increased their coverage through voluntary schemes open to self-employed workers.

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

Bolivia is the only country in Latin America that introduced a universal non-contributory pension (BONOSOL) and Brazil has a similar system for rural workers (FUNRURAL)<sup>13</sup>. Chile, a pioneer country in introducing the privatization of the pension and health systems, is taking the lead introducing a non-contributory pillar that guarantees a solidarity pension to all citizens after 65 years old perceiving a pension of less than 150% the minimum wage. It will be universally granted, but efficiency is ensured by gradually reducing the subsidy for those who perceive other pensions, thus reducing the need for public funds and providing incentives to contribute to the system. In fact, the resulting model establishes a mid-way for non-contributory pensions, since it is universal for all citizens, but it recovers partly the fiscal contribution from the high income pensioners.

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

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

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<sup>13</sup> The public funds involved are the highest in Bolivia (1,2% of GNP) and are estimated for the quasi-universal pension of Chile at 1,0%, compared to the focused pensions in the Region that are usually below 0,5% of GNP.

## **D. A different view on formalization: From informality to economic citizenship**

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

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

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

Micro-enterprises present a paradox. Large enterprises are shifting strategies to improve competitiveness and increase productivity, by adopting more flexible productive systems to smooth supply-side fluctuations; by producing goods upon request, and by getting closer to customers before and after delivering the goods. This is the kind of approach traditionally followed by small businesses. A new opportunity is opening up.

Yet, to take advantage of it, micro-entrepreneurs must radically alter their behaviour by going through a process of cultural change. They must move from individualistic ways of doing business, driven by the imperative of succeeding by any means in a wild competitive environment, to a culture that seeks the benefits of pooling productive resources as well as associating with other producers in their efforts to gain access to the marketplace. Previous ways of relating to customers should change too, and new forms of communicating with different actors should be explored. From working on an individual basis and being barred from credit in an environment in which he or she usually entertains a personal relationship with customers, the entrepreneur must start producing for a market in which customers are faceless, request good quality, expect timely services and expect professionalism. The informal sector operates in flexible ways but it is culturally unprepared to produce for demanding markets

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

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

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