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# Informality Revisited

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## Abstract

Maloney develops a view of the informal sector in developing countries primarily as an unregulated micro-entrepreneurial sector and not as a disadvantaged residual of segmented labor markets. Drawing on recent

work from Latin America, he offers alternative explanations for many of the characteristics of the informal sector customarily regarded as evidence of its inferiority.

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## **Informality Revisited \***

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## I. Introduction

Three decades of research have not yielded consensus either on the definition of the informal sector or its *raison de ser*.<sup>1</sup> Broadly speaking, the small-scale, semi-legal, often low-productivity, frequently family-based, perhaps pre-capitalistic enterprise continues to employ between 30% and 70% of the urban work force in Latin America. A long tradition views informal workers as comprising the less-advantaged sector of a dualistic or segmented labor market.<sup>2</sup> Above market-clearing wages force workers to queue for preferred jobs while subsisting in the informal sector, that is characterized by an absence of benefits, irregular work conditions, high turnover and, overall, lower rates of remuneration. A recent variant on the dualism view, albeit with different emphasis, sees informalization as an effort by firms facing international competition to reduce these legislated or union induced rigidities and high labor costs, particularly through subcontracting production out to unprotected workers.<sup>3</sup>

Recent evidence suggests that that such a view does not convincingly describe the Latin American case. This review, while looking at several countries, draws particularly heavily on my own work looking at Mexico and does not pretend to do provide an exhaustive account of the literature. Nonetheless, this particular case is an important one for several reasons. First, despite compelling descriptions of the inflexibility, inefficiency and costliness of the Mexican labor code,<sup>4</sup> the usual sources of wage rigidity that would segment the market seem absent: minimum wages have not been binding for the last decade, unions to date have primarily been concerned about preserving employment rather than raising remuneration, and wages have shown

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<sup>1</sup> See Peattie (1987), Fields (1990), Turnham & Eröcal (1990), Tokman (1992), Portes and Schaffler, (1993) for excellent overviews.

<sup>2</sup> The Harris-Todaro (1970) model is perhaps the traditional statement of this view. See most recently Chandra and Khan 1992, Chandra 1994, Loayza 1994.

<sup>3</sup> See Beneria 1989, Portes, Castells and Benton 1989, Portes and Schaffler 1989, and Roberts 1989 in the Structural Articulation school. Piore and Sabel, 1987, Gordon, Edwards and Reich, 1983, more generally in the decentralization school.

<sup>4</sup> See Davila Capalleja (1997)

extraordinary downward flexibility during crises.<sup>5</sup> Second, Mexico is blessed with excellent panel employment surveys that allow following workers among sectors over time and observing how their earnings may change. The view that emerges from these data, time series data from other Latin American countries, and global cross sectional data correspond more to an unregulated entrepreneurial sector that behaves like small firm sectors everywhere, than one comprised of involuntary, disadvantaged, precarious, or underpaid workers.

*The core of the informal sector- the self-employed*

Self-employment in Mexico constitutes the largest source of employment among men (25%), after formal salaried employment (50%). Table 1 shows that, of those workers who started in the formal salaried sector but move into informal self-employed sector 15 months later,<sup>6</sup> two-thirds report moving voluntarily, citing a desire for greater independence or higher pay as the principal motives. These findings are consistent with the sociologists Balán, Browning and Jelin's (1973) extensive interviews with Monterrey workers who state that being one's own boss was well-regarded and that movements into self-employment from salaried positions often represented an improvement in job status.<sup>7</sup> This also broadly consistent with interview data from Argentina: A small survey in the province of Jujuy revealed that 80% of the self-employed had no desire to change jobs and under 18% saw self-employment as a temporary activity before they found a "real" job.<sup>8</sup> In Gran Buenos Aires, another survey found that while 36% would have

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<sup>5</sup> See Maloney and Ribeiro (1998) and Maloney (2000)

<sup>6</sup>This is done by linking the Encuesta Nacional de Micro-Empresas (ENAMIN) with the Encuesta Nacional de Empleo Urbano (ENEU). The ENEU permits following workers over a 15 month period and hence studying their transitions among sectors.

<sup>7</sup> These results are very close to Gottshalk and Maloney's (1985) finding that roughly 70% of U.S. job changes are voluntary. Put differently, if self-employment given the common earnings differentials, are close substitutes for formal salaried work, the implied rates of involuntary entry would be normal by the standards of a flexible industrialized country market.

<sup>8</sup> Micro-enterprise Study for Jujuy, Consultoría Nordeste, Fondo de Capital Social (FONCAP).

preferred to work more hours, only 26% were looking for other work.<sup>9</sup> In Paraguay, only 28% of those in the informal sector stated a desire to change occupations. Among those often thought to be the worst off, informal workers, the percent rose only to 32%.<sup>10</sup>

Panel data from the Mexican National Urban Employment Survey (ENEU) show that, as in industrialized countries, self-employment is not an entry occupation from school and there is little evidence that the sector serves as a holding pattern for young workers. Transitions into self-employment from the other paid sectors occur 4 to 6 years later than transitions into formal or informal salaried work leaving the mean age 8 years higher than the next closest sector.<sup>11</sup> This is supportive of the findings of Balán et. al., and increasingly elsewhere, for a "life cycle" model where workers enter into salaried work, accumulate knowledge, capital, and contacts, and then quit to open their own informal businesses.<sup>12</sup>

The Guadalajara sociologist Gonzalez de la Rocha (1994) is almost certainly correct that for many older workers, the sector does provide a safety net by offering "insecure occupations (such as the services) in which their age is not a limitation after they have been kicked out of the formal manufacturing or formal services." This dynamic may have been of particular relevance during the economic restructurings of the 1990s where older displaced workers may have found their skills obsolescent and little demanded in the emerging sectors. She does also, however, suggest some degree of voluntary movement when she says that "Older men may also find the pace of industrial (formal) work too arduous and leave such jobs."<sup>13</sup> This more voluntary take is stressed by her anthropologist colleagues Selby, Murphy and Lorenzen (1991) who note the

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<sup>9</sup> SIEMPRO/FONCAP (1998) "Perfiles de la Microempresa".

<sup>10</sup> Dirección General de Estadística, Encuestas y Censos, República de Paraguay, "Sector Informal," based on the Encuesta Integrada de Hogares 1997/1998.

<sup>11</sup> See Maloney (1999), and Aroca and Maloney (1998).

<sup>12</sup> See Lopez-Castaño (1990) in Colombia, Fields (1990), and Peattie (1982) who find a tendency for employees of large firms to leave and open their own. This is likely to be due to the same kind of credit constraints found binding in industrialized countries. See Evans and Jovanovic (1989).

<sup>13</sup> See Maloney (1999) Labor Markets Regional Study. The anthropology literature also weighs in on this point as well when Selby, Murphy and Lorenzen argue "On average, opportunity costs to these worker in terms of foregone earnings in, say, registered blue-collar employment may be quite low.(p. 147)

“surprising desirability of informal sector employment as the basis for a household earning strategy, particularly for poorer, older household with lower educational qualifications.”<sup>14</sup>

On balance, sociological and anthropological studies are consistent with the findings of the Mexican, Argentine and Paraguayan micro-enterprise surveys that most self-employed choose to be so, as well as the view that workers may enter formal sector employment initially partly as a means to accumulate human and physical capital. This leads to an intriguing inversion of the traditional dualist view. If firms must pay “efficiency” or above market clearing wages to dissuade their workers from opening their own firms, this creates a segmented market. It may be the attractiveness of informal self-employment that causes dualism rather than a segmented market causing informality.<sup>15</sup>

*But don't informal workers earn less?*

Table 1 shows that Mexican workers who voluntarily enter self-employment *gained* roughly 25% leaving salaried formal employment. However such wage comparisons are fundamentally meaningless and we should probably not use them as measures of segmentation and job quality. The reason is that if workers were to choose between sectors, they would take into account not only the wage, but all other characteristics and benefits associated with each possible job.

Several examples may make this clearer. First, if the formal sector pays benefits--pensions, health insurance, housing subsidies, day care-- which the informal sector does not, then in a market with no distortions, the wage in the unprotected sector would need to be above the formal sector to compensate for the lost benefits. This higher wage, of course, would not imply a superior job--only that more of the total remuneration was paid in cash instead of benefits. On the other hand, income taxes support public goods from which tax-avoiding informal workers can

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<sup>14</sup> Selby, Murphy, Lorenzen 1991 144

<sup>15</sup> See Maloney (forthcoming) and Krebs and Maloney (1999) for an elaboration of this view.

not be excluded (national defense for example), and therefore dictate that formal sector workers need to be paid more to compensate for the taxes they can't avoid. Further, formal work-places may be cleaner and safer, but, as in the industrialized world and as table 1 suggests, being ones' own boss and having flexibility is very valuable too and is worth taking a wage cut for. Finally, starting a business is risky anywhere and we should expect to find higher incomes among this group to compensate them for this risk.

Though informal salaried workers always earn consistently less, this may be due to the fact that they are often related to the owners of the enterprises where they work and thus may receive unobserved payments in kind (food, lodging). Further, to the degree that the sector appears to play a job training role for young workers, some fraction of the salary may be deducted to cover implicit training costs.

To summarize, in a market with no distortions and hence no segmentation, workers would equate utility, or the total "package" of benefits, not just wages. To establish segmentation, we would need to add up all of the factors discussed above, many of them unmeasurable, and show that formal sector workers were better off- an impossible task. This implies that comparisons of wages cannot be tests for segmentation. It also implies that the fact that informal salaried workers may earn less than formal salaried workers does not imply that they are "poorer" when measured in terms of total welfare.

*Isn't the informal sector the safety net for displaced formal sector workers?*

The traditional "dualistic" view would argue that as the economy enters a recession, we should find workers being forced into the informal sector, driving down wages there relative to the formal sector wage. This does seem to be the case in Colombia after 1995, a period of deep recession due to a financial crisis combined with a very ill-advised but very dramatic rise in the minimum wage that accentuated the segmentation in the economy. Figure 1 shows that the relative size of the formal sector relative to the informal self-employed sector fell while its

relative wage rose- exactly the pattern predicted by the dualistic view. But figure 2 suggests that the 1987-93 period was very different in Mexico. Here the share of the workforce in self-employment grew at the same time that the self-employed went from earning roughly the same amount as formal salaried workers, to 30% more by 1992. The boom in construction and other non-tradeables offered many good jobs to informal skilled workmen, and this is when they choose to open their businesses.<sup>16</sup> This pattern reverses somewhat going into the crisis of 1995 where there is an increase in the size of the self-employed sector at the same time that relative self-employed earnings are falling. But, the point here is not to show that the informal sector *never* serves as a safety net. Rather, the point is that most of the time, the vast majority of entrepreneurs want to be in the sector, that it should not be treated as inherently inferior.

Perhaps figure 3 is the most provocative. It suggests that, in Brazil, informal self-employment rises at the same time that its relative earnings are roughly stable or rising. As some observers have argued, during the periods of high inflation, self-employment is preferred: formal wages are indexed intermittently and hence lose purchasing power while the self-employed can index daily. The post -1994 period after stabilization, however, suggests a long period of decline in relative formal/informal incomes and a decline in formality. Without question, as the ILO and the Economic Commission on Latin America have noticed, informality is rising across the period. But the critical question is whether it was voluntary!

Another counterintuitive finding appears in table 2. Here we're use panel data from Mexico and Argentina to ask the unemployed what sector they entered from. Surprisingly, 75% of the unemployed in Mexico and 64% in Argentina were informal previously. And although their unemployment spells are 30% lower than those of formal sector workers, it is not the case that they instantly find new informal jobs. So the sector is not simply or even primarily absorbing the unemployed from the formal sector. As we'll see later, there is a logical reason why this may be the case.

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<sup>16</sup> See Maloney (1998)

*But why would workers voluntarily give up these formal sector benefits?*

There are several reasons why workers may be willing to voluntarily become “unprotected” and rely more on informal safety nets. First, developing country micro-entrepreneurs may not be fundamentally different from their counterparts in the industrialized world who also take on responsibility for medical insurance or saving for retirement that was previously covered by their employers. Second, since in a market with flexible wages, the cost of employer-provided benefits is partially passed down to workers the form of lower wages. If workers don’t value the benefits as much as the fall in wages, they will seek out jobs in the unregulated sector where remuneration is entirely monetary. This might happen if social security or health benefits provision is very inefficient, if there are very weak linkages between benefits and contributions, or if one member of the family is already formal and hence the rest of the family already receives benefits. Third, Balán et. al.'s interviews suggest that the very legislation that is thought to induce rigidities into the labor market in fact stimulates such turnover and encourages workers to leave salaried employment. The paucity of openings for promotion on the rigid *escalafon* as well as the ceiling on mobility opportunities for manual workers makes self-employment the remaining outlet for further advancement. These last two issues suggest that, in contrast to the usual view, the extant labor protections may make formal sector work less desirable, rather than less attainable.

*But doesn't the large size of the informal sector imply large labor market distortions ?*

The argument that informal employment can be desirable is most compelling where micro- firms can offer remuneration comparable to that earned in the formal sector- among low education workers unlikely to generate much firm specific capital. Observing Mexican informal workers, the anthropologists Selby, Murphy and Lorenzen confirm that “On average, the opportunity costs to these workers in terms of foregone earnings in, say, registered blue-collar employment may be quite low.”(p. 147) This view is supported statistically by logit analysis of

Argentine and Mexican worker movements between sectors that finds that they become less likely to leave formal employment for self-employment, or any other informal sector, as their education level increases. At a global level, figure 4 suggests that as formal sector productivity increases with development, the share of the workforce in self-employment falls. When we control for productivity (or GDP) and other relevant demographic variables, Latin America does not have an unusually large share of its workforce in informal self-employment: Mexico and Brazil are below average, perhaps suggesting more flexible than average labor markets. Argentina is above average suggesting the reverse.

This same pattern appears within countries if we assume that more educated workers will have higher productivity in firms than in self-employment, either because of associated firm specific capital or greater specialization. Figures 5a-5b plot the ratio  $SE+FS/SE$  vs years of education for Argentina, Brazil and Mexico. We find the same downward slope in all countries that suggests that as workers have more education, the opportunity cost of being self-employed rises and correspondingly they are more likely to choose to be salaried workers.

Another way to approach the question is to assume it exists because of distortions and ask how much remuneration in the formal sector would need to fall to eliminate the informal sector. Given that own wage labor demand elasticities in manufacturing tend to range from  $-.2$  to  $-.5$ <sup>17</sup> a 10% increase in the size of the formal sector would require a 20-50% decrease in formal sector remuneration. If, as is often the case, the informal sector is half of the workforce, the necessary fall in formal sector wages implied is vast and far above any measured differentials in the two sectors. Further, in figures 5a-5c, we might argue that less educated workers are more likely to find minimum wages binding. However, the evidence for such distortions we might not expect the smooth kernel density plots in all three countries find no impact of minimum wages on formal wages (See Maloney and Nunez 2001).

*Isn't informal work precarious?*

Many of the characteristics we associate with informality are, in fact, natural by-products

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<sup>17</sup> Fajnzylber and Maloney (2000) estimate own wage labor demand elasticities for blue collar manufacturing

of the fact that the informal *cuenta-propista* or patron is fundamentally a micro-entrepreneur--the owner of a small firm. The industrialized country literature on firm behavior offers two important findings about such firms. First, there is a wide range of sizes among longstanding firms determined by such factors as how efficient or hardworking an entrepreneur is, how well-placed his/her firm is, what the logic of the production process is etc. This means that the existence of many small firms does not necessarily imply failure of either labor or credit markets. It may be that the reason that 80% of micro-firms have only one or two employees and tend to be family based reflects a logic that has roots in the tradition of the family farm, or reflects the sustainable reach of informal contracting relations. This could explain, for instance the finding that only 10% of urban Mexican micro-firms report plans for expansion and only 9% report that lack of credit is a major business problem.<sup>18</sup>

A second finding about small firms everywhere is their extraordinarily high rates of failure. Seeking to explain the US case, the economic theorist Jovanovic (1982) argues that this is due to the fact that entrepreneurs cannot know how good their location is, or how good an entrepreneur they are until they actually start the business. Very soon after starting, many find that they are not viable and fail. The sociology literature provides striking confirmation of this insight when Balán, Browning and Jelin argue that although self-employment is a goal for many Mexican workers:

Becoming self-employed involves a large risk, especially for those men who had stable and secure jobs. Income is uncertain, in particular during the first perilous years of the business. Often the men lack the financial and administrative skills needed for successful operation of the enterprise. Most men are aware of the fact that many small shops and stores close soon after opening. Some men therefore proceed with much care when they decide to become self-employed. (p 216-217).

That said, rough calculations from the Mexican micro-enterprise survey suggest that these firms, show high failure rates, but not particularly higher than those in the US.

If we add a new view of “formality” to this picture, we can generate most of the

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workers to be -.29 for Chile, -.49 for Colombia, and -.18 for Mexico.

<sup>18</sup> See Cunningham and Maloney, forthcoming.

characteristics of the sector, but without implying any inferiority or undesired precariousness. Alec Levenson and I treat “formality” as participation in the numerous institutions of civil society: federal and local treasuries, governmental programs such as social security (including pensions and health care), the legal system, the banking system, health inspection, firm censuses, trade organizations, civic organizations, *etc.* These, of course, have costs in terms of compliance with legal norms which very small firms can choose to avoid in many developing countries. Small firms are anchored in social networks of family and immediate neighborhood that allow them to enforce implicit contracts, insure against risks *etc.* and participation in the formal institutions of civil society is needlessly expensive. However, as firms grow they increasingly need to secure property rights or permit formal contracting mechanisms, pool risk, gain access to credit-- all things that become increasingly important as firms grow. De Soto (1989) offers a striking example where informal street vendors in Peru tried not to avoid, but to pay their taxes since this would guarantee them some property rights over their pitch and hence offer some security to investments they wanted to make. Statistically, the data from the Mexican micro-enterprise survey suggests that firms do become more formal with age and size.<sup>19</sup>

Combining the two characteristics of micro-firms and our notion of formality implies that small firms will have higher costs, are likely to be informal, and will have very high failure rates. Though this corresponds exactly to the standard picture of the stagnant, precarious, unprotected informal worker familiar in the literature, it is, in fact, the opposite. It emerges naturally from the workers trying their luck at entrepreneurship (risk taking), often failing, and not engaging in the formal institutions until they grow. In sum, there may be nothing pathological about the informal sector firm and its existence may be largely unrelated to questions of labor market dualism or even credit market distortions.

But this also may explain the high rates of entry into unemployment found in table 2. If small firms have high mortality rates, both owners and the workers are more likely to find themselves without employment and searching for a new job.

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<sup>19</sup> Levenson and Maloney (1999)

Gonzalez de la Rocha provides a compelling explanation of the life cycle pattern discussed earlier based on the household's capacity to manage these risks. Her interviews show that the heads of young families are more likely to be found in manufacturing while heads of "consolidated" households can move into less onerous but more risky informal service jobs precisely because their mature children provide a hedge against the risk. Further, Balán, Browning and Jelin argue that it is common for workers contemplating opening a firm to maintain their formal sector job until the micro-enterprise is safely established, perhaps staffed by the wife or mature children, thereby effectively maintaining a diversified portfolio of income streams.<sup>20</sup> In sum, for workers desiring to become self-employed, there are informal strategies for managing risk.

*Doesn't the informal sector show lower overall productivity growth?*

This is very likely to be the case, but not because of informality per se. Traditionally, the big gains in productivity occur in the tradeables sectors and often (although not exclusively) in manufactures. This differential in productivity growth underlies Balassa's (1964) theory of why the real exchange rate appreciates as countries develop.<sup>21</sup> Informal businesses tend to be concentrated in services, transport, commerce in the like where productivity gains are hard to achieve: A haircut still takes about 20 minutes in Washington or Bogotá. But this doesn't mean that wages of informal barbers won't rise over time. As productivity rises in the formal

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<sup>20</sup> "The worker in the Fundidora ...for instance, was extremely cautious when he decided to enter the ranks of the self-employed, after twenty years in the plant. His timing was almost perfect. For five years he had been in the highest position he could expect to attain, so no more mobility could be anticipated within the plant. His youngest son was three years old, and now his wife would be more free of household concerns and could help in the store. He had saved a considerable amount of money during his years in the steel plant. In any even, when he first opened a small shoe store, he did not give up his job in the factory until he was sure of the success of his business venture. He moonlighted in his store for three years, his wife tending it when he was not present. During the first year of operation the store lost money, and in the second year it broke even. At the end of the third year it turned a profit so he decided to leave the factor and devote his full time to the store." p. 216-217.

<sup>21</sup> Productivity growth rises in tradeables pushing up wages in both the tradeables (formal) and non-tradeables (informal) sectors. But since there has been no productivity growth in non-tradeables, their price must rise relative to tradeables prices and the exchange rate defined as  $P_t/P_n$  must appreciate. Rogoff and Obstfeld's text book (1996) does a nice job of both laying out the modern view of this as well as providing some empirical evidence

tradeables sector, workers are slowly pulled from the informal sector, and wages must rise there to keep barbers from moving into formal manufacturing.

*Isn't formality largely a way for larger firms to avoid protecting their workers?*

Since only 20% of Mexican informal workers are found to be affiliated with larger firms clearly sub-contracting relations are not the dominant modality of informal firm behavior. But further, it appears that the path of earnings across time of those who worked in subcontracting relations followed very closely those who were independent. This suggests that common motivations may underlie a worker's decision to engage in sub-contracting, and that the sector may not represent inferior work. This is supported by the sociologist Bryan Roberts'(1989) interviews with Guadalaajaran workers that suggest that, given the very weak unions and low wages in Mexico, informalization is not primarily a strategy for reducing remuneration and worker control over production: "Market uncertainty and the large number of income opportunities in the city mean that it is useful for *both* employees and employers to have flexibility in allocating labor."(italics added, p. 48). More generally, it is possible that sub-contracting is not so much a way of avoiding labor legislation, as avoiding the inefficiencies in it. The differentials between costs to firms and value to workers of benefits discussed previously offer a benign interpretation of informal subcontracting as a way of reducing firm costs where contract workers gain some of the value of benefits foregone. Some caveats are in order for the end of the 1990s. Here, remuneration to subcontracted workers in Mexico appears to fall relative to self-employed and to formal sector workers suggesting that the quality of employment may have fallen.

*Doesn't the large number of women in informal self-employment suggest discrimination in the*

*formal sector?*

The high level of female participation in self-employment which has sometimes been attributed to discrimination that leaves women regulated to inferior jobs. Cunningham (1999) found that, while it is true that single mothers have high levels of participation in informal self employment, the fact that single women without children have the highest rate of participation in *formal* jobs of any group, male or female, makes discrimination seem unlikely. This does not, of course, preclude discrimination against married women or those with children who may be likely to be absent for work for long periods. But Cunningham argues that the concentration of these two groups in self-employment driven by the need to balance household responsibilities. For women attempting to raise children as well as contribute to household income, the flexibility of the sector may make the sector even more desirable than for the men discussed earlier.

*Aren't the informal salaried the most disadvantaged?*

Even if the self-employed benefit from being their own bosses, the mainstream view is that those who work for them are the very worst off of the urban workforce: salaried, yet without benefits. We've already discussed how the fact that they appear to earn lower wages tells us nothing about whether they are truly worse off. Further, rather than being a stagnant group of disadvantaged workers, the sector appears to serve primarily as the principal, although not exclusive, port of entry for young, poorly educated workers into paid employment. The mean age in Mexico of 29 is 5 years below that of formal sector and contract workers and 14 years below that of the self-employed and the pattern is broadly similar in Argentina. The Mexican transition data show a high degree of mobility between school, unpaid work and, to a lesser extent, unemployment that suggests a pool of workers not yet tracked into regular employment. One scenario is that while and just after completing school, many students help out at the family business, and eventually get paid. Once becoming salaried informal, workers spend on average

only 2 years doing this before moving on to other paid work. The brevity of tenure is the same as that found in Brazil by Sedlacek et. al.(1995) and is similar to the U.S. where the median tenure for young workers 16 to 24 years of age is only 1.4 years and 25 to 34, 3.4 years.<sup>22</sup> Further, if Hemmer and Mannel (1989) are correct that in many countries informal small enterprises train more apprentices and workers than the formal education system and the mostly government job-training schemes together, these years to large degree may constitute continued schooling. Even if this pattern of graduation from school to unpaid to informal salaried work to other modes of work represents the queuing that the dualistic literature might predict, the wait in informal salaried work is not long.

The sector appears precarious for two reasons. First, Balán et. al. argue that this period of life for young workers is one of “shopping around” and trying out various possible life choices, and hence they will show short tenure. Second, the vast majority of informal salaried workers are employed by informal micro-firms which, as discussed earlier, have higher turnover rates.

## **VII. Conclusions**

The view of the informal sector sketched here is not meant to suggest that in periods of great recession or in countries with very distortionary minimum wages and regulation the traditional dualistic view would not be a more appropriate model. But what does seem clear in Mexico and arguably other Latin countries is that much or most of the sector represents a healthy, voluntary small firm sector that should be treated as such. Proposals for extending credit or other micro-firm services should be grounded in a solid understanding of the dynamics of these enterprises and of barriers to their growth and absorption of labor. Proposals to provide social protection to the sector need to be grounded in an understanding of the reasons that entrepreneurs choose not to be formal.

Nor do I mean to imply that there is no need for reform of labor legislation. The

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<sup>22</sup> BLS News, USDL 92-386 for 1991.

traditional emphasis on rigid wages driving segmentation is probably not correct. However, I have argued, for example, that informality may arise partially as a response to inefficiencies in the provision of medical benefits or pensions, promotion systems not based on merit, or other distortions that make being paid in cash informally more desirable. The recent reforms in Chile, Colombia and Mexico that have sought to bring benefits in line with the implicit taxes that workers pay, for instance individual accounts for retirement pay, are important steps to reducing incentives to being informal. More fundamentally, informal employment in firms of relatively low technology and capital intensity can only be attractive if the overall level of labor productivity in the formal sector is low also. To the degree that current legislation impedes investment in physical or human capital, or prevents the efficient organization and operation of firms, it perpetuates the low levels of productivity throughout the economy.

Finally, I do not mean to suggest that the sector is not relatively poor. However, the poverty is a function of low levels of human capital and whether the worker is formal or informal is largely incidental. A workers with few skills that would be rewarded in the formal sector may prefer to be independent: S/he may prefer being the master of a lowly repair shop to endlessly repeating assembly tasks in a formal maquila. Neither job will lead to an exit from poverty, but the informal option may actually offer a measure of dignity and autonomy that the formal job does not.

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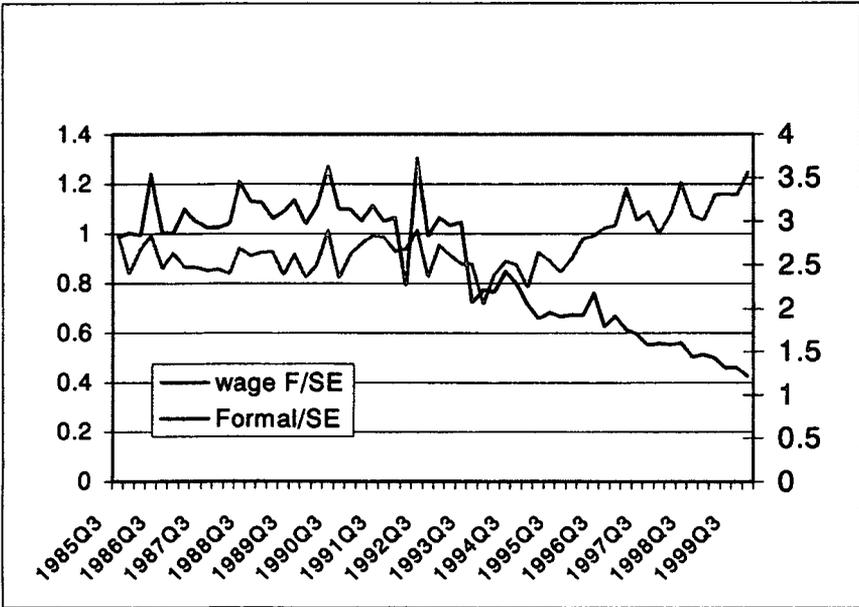
<b>Table 1: Real Hourly Wage Differential: Formal Salaried to Informal Self Employed ( In percentage change)</b>			
	<i>Share of Respondents</i>	<i>Mean Differential 3/</i>	<i>Median Differential</i>
<i>National Urban Employ. Survey (ENEU)1/</i>	100	27.3***	23.6***
<i>Micro-enterprise Survey (ENAMIN):2/</i>			
<i>Reason Left Previous Job</i>			
More Independence	35	21.6**	19.6*
Higher Pay	32	16.7	12.1
Involuntary	29	-14.7	-4.1
Total	100	12.6**	10.0**

1/ Adjusted for hours worked and taxes. 2/ Adjusted for hours worked, taxes, capital costs, unpaid workers. 3/ Mean employs Huber weights to redress non-normality. \* = sig. at 10%, \*\* 5%, \*\*\*1% level.

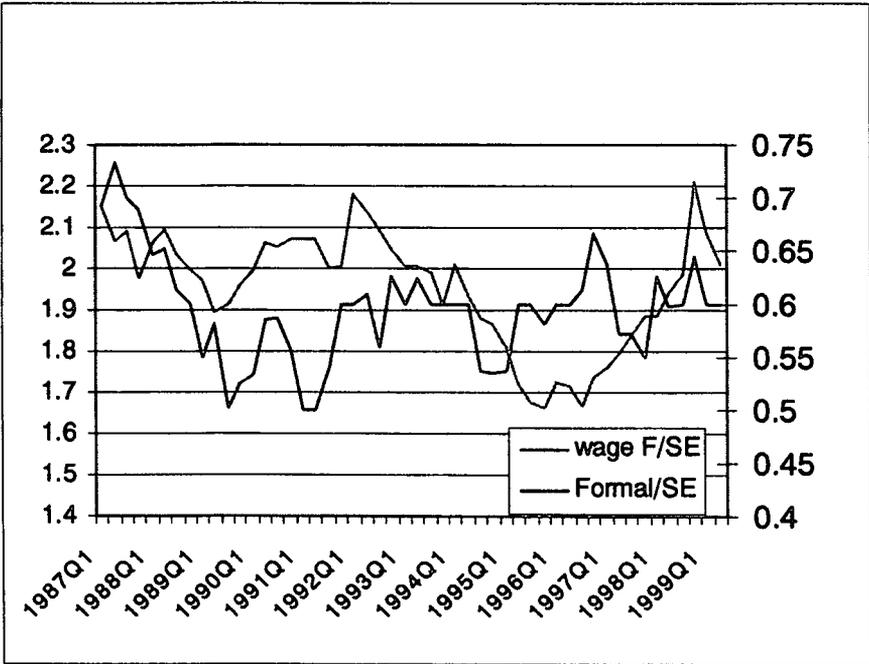
**Table 2: Sector of Origin of the Unemployed**

Sector of Origin	Argentina 1/		Mexico	
	All	Paid	All	Paid
Informal Self-Employed	18	38	9	40
Salaried Informal	12	26	7	35
Formal Salaried	17	36	5	25
Previously Unemployed	34		19	
Previously Out of Labor Force	6		44	
School Graduates	13		16	
Total	100%	100%	100%	100%

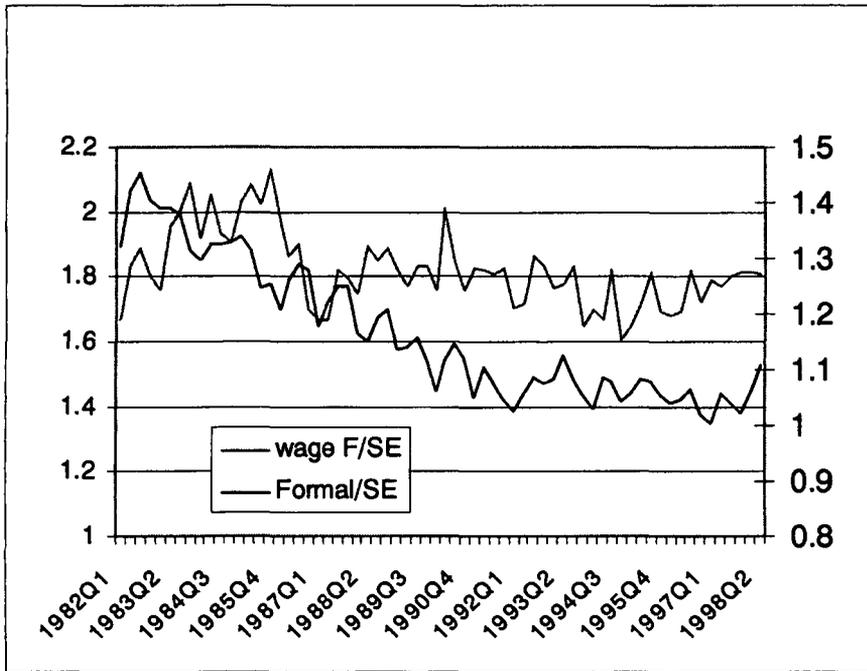
Note: Argentina includes only household heads while Mexico includes all possible workers. This is responsible for the very high share of OLF in Mexico who may mostly be students.



**Figure 1: Colombia, Relative Sector Size and Earnings**



**Figure 2: Mexico, Relative Sector Size and Earnings**



**Figure 3: Brazil, Relative Sector Size and Earnings**

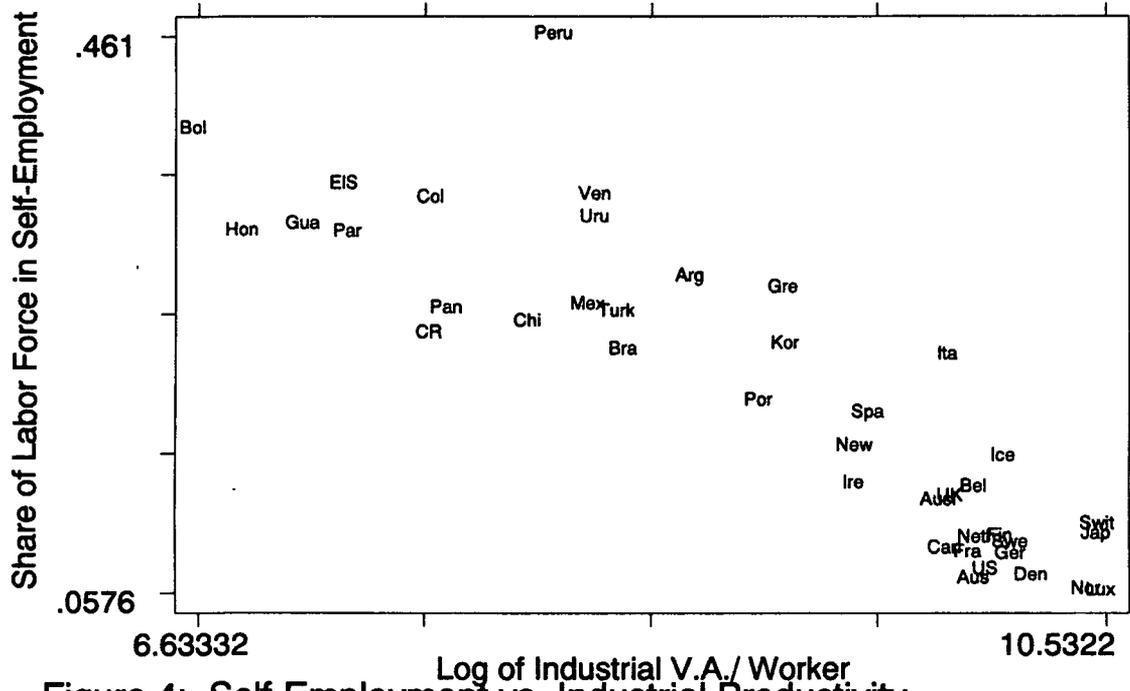
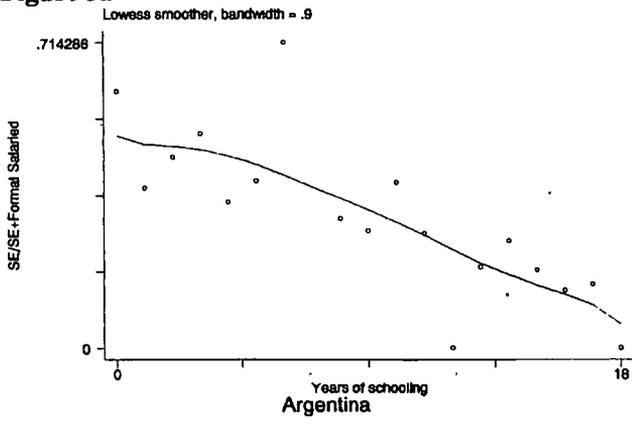
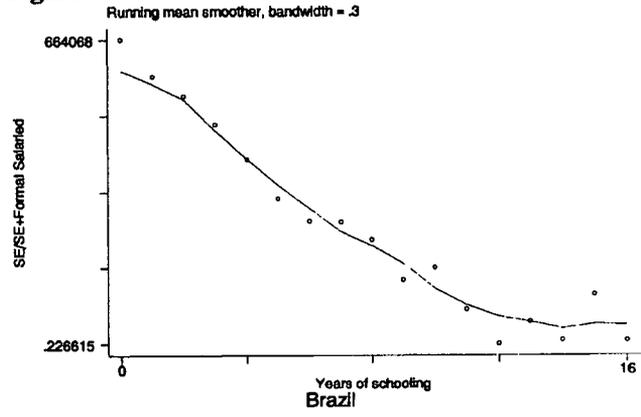


Figure 4: Self-Employment vs. Industrial Productivity

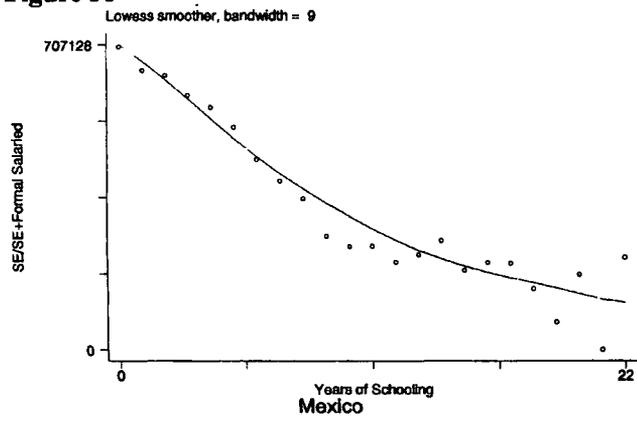
**Figure 5a**



**Figure 5b**



**Figure 5c**









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