Edited by

A. Lawrence Chickering and Mohamed Salahdine

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THE INFORMAL SECTOR IN FIVE ASIAN AND NEAR EASTERN COUNTRIES

International Center for Economic Growth

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Preface

In many developing countries, where jobs in officially licensed enterprises are scarce, much of the population makes a living by working outside the official tax and regulatory systems. These people, who make up the informal sector, are innovators, skilled at surviving, and sometimes prospering, in a highly regulated environment. Although the informal sector is an important source of jobs, income, and even housing, its participants lose their full rights as citizens by operating outside the legal economy.

In April 1989, economists from Bangladesh, Egypt, Morocco, the Philippines, Sri Lanka, and Thailand traveled to Peru to observe the work of Hernando de Soto, whose 1989 book *The Other Path* brought international attention to the plight of informal sector participants. The International Center for Economic Growth then asked these six economists to analyze the informal sector in their own countries, examining the relevance of de Soto's approach. The results, except for the study of Egypt, which could not be completed in time for publication, appear in this volume.

The contributors' conclusions provide important lessons for policy makers in developing countries. The country studies show how governments, which often view the informal sector as a problem to be solved by law enforcement and regulation, actually ensure its continuation through misguided policies.

If developing countries are to advance along the development path, they must bring informal sector participants into the legal economy, to share in both the benefits and the costs of formal economic activity. We expect *The Silent Revolution* to bring a new understanding of the role of the informal sector in the development process to both scholars and policy makers.

Nicolás Ardito-Barletta
General Director
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Panama City, Panama
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Introduction

Since the beginning of the 1970s, the informal sector—or underground economy, as it is commonly known in the industrial countries—has been a subject of increasing attention for scholars and policy makers searching for answers to the challenges that face many developing countries. At first, attempts to understand the large numbers of individual workers and firms doing business "off-the-books," outside of the official, "formal" economy took a negative view. The initial studies, beginning with a 1972 study by the International Labor Organization (ILO), saw the sector as essentially dysfunctional—a problem that needed fixing. But as the failure of the prevailing bureaucratic model of development became clear, a new attitude toward the informal workers and their potential role in development began to appear.

The bureaucratic model sees development—to borrow an analogy from physics—in Newtonian terms, viewing society as a machine and seeking to perfect the machine in an effort to make development happen. This theory has thus tended to focus on what it came to regard as the optimal economic conditions, related to resource endowments, demographic rates, and appropriate technology, among other economic variables. All attention to poverty and the poor focused on dysfunction —or "what the poor lacked." This focus led, in turn, to a regulatory, bureaucratic approach to poverty with an emphasis on "fixing" the poor.

According to this model, the poor in developing countries were a passive and dispirited people, whose dysfunction prevented real self-improvement. Their only hope, therefore, was for state or foreign aid that would provide various social services, including training, health services, housing, and so on. As confidence in this model declined, however, observers in developing countries began to notice something quite different. Faced with a lack of job opportunities in the formal sector, many of the poor were surviving by working for themselves or for family members. Operating outside of the rules and regulations of the formal economy, these businesses were providing a wide variety of important goods and services. The reason for the poverty of these people did not seem to be lack of entrepreneurial initiative.

The effects of the bureaucratic model of development and the role of the informal sector became the subject of heated debate following the publication of Hernando de Soto's 1987 study of the informal sector in Peru, *El Otro Sendero* (published in English as *The Other Path*) (de Soto 1989). De Soto argued that government institutions and policies, supported by an implicit coalition of traditional conservatives and socialists, were systematically excluding the poor from full participation in the economic and social life of Peru. He also argued that people in this excluded "informal sector" were being held back from employing their entrepreneurial skills to improve their own lives, and that they represented a resource that could make an important contribution to economic and social progress.

De Soto's book set off a debate both about Peru and about the role of the informal sector in developing countries everywhere. If he was correct about Peru, the next, obvious question was whether his analysis described that country uniquely or whether it represented an important new theory about developing countries generally. This study was initiated to help answer that question, exploring in several Asian and Near Eastern countries many of the issues and questions he raised in Peru.

The roots of the informal sector problem can be found in the bureaucratic model of development, which focuses on government promotion of large-scale enterprise and advanced technology as the essential tools in a successful development strategy. This model, accepted and followed by many policy makers in developing countries and some scholars until the early 1970s, was influenced by the belief that development depended on transforming traditional society, which theorists believed was retrograde and therefore a "problem" that policy should aim to "overcome." This model looked to bureaucratic enterprises to replace traditional economic and social structures with modern (post-traditional) ones.

This development model was highly Western, rationalistic, and organizational. It had a weak concept of individuals and of citizenship.

It also devalued local community, seeking instead to build a national community linked to nationalism and the nation state.

By playing down the role of individuals in development, the policies associated with bureaucratic industrialization aimed to impose development from the top down. They paid little or no attention to individuals or firms. Unfortunate in itself, this approach brought with it another unfortunate by-product: it often turned into an engine for generating class privileges, both for people lucky enough to get jobs in the bureaucracy administering the whole process and for those lucky enough to get jobs in favored (subsidized) sectors. These sectors, in which enterprises are heavily regulated (if not actually owned) by governments and receive subsidies and other special treatment, often become monopolies living off the public purse.

The bureaucratic/industrialization theory dominated the thinking of some theorists and many policy makers in the 1950s and 1960s, but by the mid-1970s its failures were becoming apparent. The principal difficulty was that it produced contradictory social and economic results. In particular, the dichotomy that was believed to exist between the "modern" and "traditional" sectors seemed less and less relevant as a means of explaining the economic and social structures that were actually emerging in most developing countries.

This dichotomy seemed especially irrelevant compared with another, increasingly evident dualism between the official, formal economy of large enterprises subsidized and encouraged by official government development policies and a second, "real" economy of small entrepreneurs operating beyond the formal economy and its supporting governmental institutions and policies. In the formal economy, the commitment to large-scale industrialization tends to shield enterprises from competition, and they employ relatively small numbers of people. In the other economy, informal enterprises operate in a free, unregulated market. They are dynamic and competitive, and they employ a large and growing fraction of urban populations. In this setting, government subsidies to large enterprises divert resources away from the informal economy and thus actively discriminate against it.

The problems in the industrialization model were especially evident in its failure to account for and accommodate the ongoing exodus from rural areas in developing countries. This exodus bore no relation either to the growth and evolution of large-scale enterprises or to the patterns of visible employment. The industrialization model regarded high percentages of self-employment and employment in small enterprises as indicators of poverty and economic failure. Thus, both theory and policy neglected the mass of microenterprises that has come to employ between 35 and 65 percent of the labor force of most developing countries and produces 20 to 40 percent of gross domestic product (GDP).

In 1972 the International Labor Organization (ILO) initiated inquiry into the informal sector and described it as a large group of enterprises characterized by unobstructed, easy entry into markets; use of local resources; family ownership; small-scale operations; use of appropriate technology with high labor intensity; reliance on training provided outside the formal education system; and operation in unregulated, competitive markets. The approach recommended was basically a social welfare one, stressing training to provide skills.

Since the ILO initiated its inquiry, the bureaucratic model of development has lost much of its following. Although the policies of many developing countries are still based on it, the reason is more political than intellectual. Experience has shown that societies are not Newtonian machines. It has shown that development policy cannot succeed if it focuses on regulating both individual behavior and economic variables from the center (aside from interventions strictly necessary to protect public health and safety). In contrast, post-Newtonian development theory focuses on *nonmaterial* factors—creation of an *environment* for releasing the energies and creativity of ordinary people to work for self-government in economic, social, and political life. This theory has inspired studies of the informal sector that seek to understand how government institutions and policies influence the incentives of participants in informal markets.

Recent studies have shown that microenterprises and the informal sector can be among the most dynamic and healthy sectors in developing economies. As such, they fill an essential role in providing jobs for large numbers of urban workers and adapting both to general patterns of economic growth and to negative shocks. Not only do the informal sector's entrepreneurs survive in the face of government-subsidized large-scale industrialization; their flexibility and adaptability have allowed them to provide essential goods and services on which large-scale, modern manufacturing enterprises depend (Webb 1975:2), such as clothing, weaving, woodwork, repair services, and production of small machines. They can provide these goods and services because of their competitiveness, their proximity, and their low unit costs.

This "real" (that is, unsubsidized) economy diffuses itself organically into diverse pores of the formal economy in myriad production, distribution, and service sectors; and it does so often in the face of masses of bureaucratic regulations. In ideal circumstances, these rules would serve legitimate public regulatory functions, protecting public health and safety. In reality, however, many of them do not serve the public interest in any significant way. They tend to become their own end, inexorably building on themselves, while multiplying transaction costs and obstructing the creativity of many of the most entrepreneurial people in developing countries—who are also often the poorest.

Although it is out of favor among economic theorists, the bureaucratic/industrialization approach to development continues to exercise strong influence over policy makers in many developing countries. In doing so, it has the effect of creating exclusive preserves for large enterprises and the wealthy people who own and control them, protecting many of them from real entrepreneurship and risk taking. This is a tragic mistake that denies many people with genuine entrepreneurial talent the opportunity to improve their own lives. It denies them full participation in the economic and social life of society, while depriving the overall economy of their entrepreneurial talents.

Besides the important functions that informal activities perform for the economic system, the spontaneous enterprise of informal entrepreneurs provides remarkable socioeconomic training in and preparation for modern (post-traditional) forms of social and economic life. In fact, the creative, individualistic activities found in the informal sector almost certainly provide a better social and psychological introduction to the rationalist individualism characteristic of modern economic life than do the large bureaucratic, hierarchical structures promoted by development theory and policy.

Providing an environment conducive to entrepreneurship requires establishing economic and legal institutions that define the rights and responsibilities of economic actors. Such institutions define the basic terms of economic and social relations among whole peoples. Encouraging entrepreneurship means creating a more open, competitive environment for the economy as a whole. As the former Eastern bloc governments have come recently (and dramatically) to understand, the most important institution for establishing such an environment is the right of private property, which creates clearly defined interests that will encourage people to take risks.

These reforms will redirect the entrepreneurial energies of those in the formal sector away from the mercantilist patterns of the present toward more productive activities, and they will greatly expand the dynamic and creative potential in microenterprises and the informal sector.

The case studies in this book are concerned with a series of questions and issues relating to this dynamic world of informal microenterprise: How important is the informal sector in economic and social life? Who is in it? Which model better describes it—the bureaucratic/Newtonian model or the self-governing/entrepreneurial one? Why do individuals and firms choose to remain informal, off-the-books, avoiding both the costs and benefits of participation in the official, formal economy? How is informality affected by policy? What policy reforms might be enacted to encourage this dynamic sector?

The question of reforms involves several very different issues. One aspect of reform entails repealing policies and regulations that obstruct entrepreneurship and enterprise without serving any legitimate public regulatory purpose. A second kind of reform involves cessation of policies that assist and allocate resources to certain "favored" sectors (especially large enterprises), thus implicitly discriminating against people in other sectors (especially microenterprises). Finally there are reforms that involve public or private efforts to empower people to contribute to economic and social development. The best examples of this are programs that provide credit to small entrepreneurs, such as the Bank Rakyat Indonesia, ACCION in Latin America, and the Grameen Bank in Bangladesh (see Muzammel Huq and Maheen Sultan's chapter herein on the latter). Other examples might include programs that encourage self-governing institutions to expand the informal workers' participation in all dimensions of political and social life, as well as control over their own lives.

Additional questions concern the political implications of the growing self-awareness of the informal sector for policy makers and the policy environment. And finally, the contributors to this book explore how people in the informal sector actually live and work—how they exist in the economy, cut off from the main financial and legal institutions that facilitate commerce. Through individual portraits of people who work in the sector, the contributors reveal what the informal sector is—who is in it and why. These vignettes show more clearly than any abstract discussion a sector whose health and vitality are far more important than the dysfunction and pathology often emphasized in regard to it.

The Experience of Peru

The background and guide for these investigations is the work of Hernando de Soto and the Instituto Libertad y Democracia (ILD) and their ground-breaking studies of the informal sector in Peru. De Soto's extraordinary findings, summarized in his best-selling book *The Other Path*, greatly accelerated concern about the informal sector in the 1980s. In the book, de Soto documents the existence of an enormous informal sector—50 percent of the labor force working full-time, with another 10 percent working part-time, off-the-books. Together, they produce nearly 40 percent of Peru's GDP. In particular, de Soto found that 47 percent of construction and 95 percent of public transportation in the capital city of Lima are informal. Of the city's

331 markets, 57 were constructed by the government; the other 274 were constructed informally.

In analyzing why such a large fraction of Peru's labor force would choose to operate outside and beyond the law, de Soto concluded that the reason was the excessive regulation imposed by the enormous bureaucratic state, which was effectively excluding Peru's informals from full participation in the country's economic life. His most-cited finding was drawn from his simulation of registering a small garment business with two sewing machines. Working six hours a day, he found it took 289 days and several bribes to go through all of the government departments and bureaus and comply with all of the regulatory requirements. The same procedures took three-and-a-half hours in Florida and four hours in New York. He concluded that most small businesspeople and entrepreneurs judge that the costs of participating in Peru's formal economy exceed any possible benefits. So they work off-the-books.

Another of his findings, which was equally dramatic, concerned the difficulties of gaining title to undeveloped land. The issue is important because the willingness to invest and improve land is very much dependent on the owner's having secure title. In Peru, when de Soto began his studies in the early 1980s, it took an estimated six years and eleven months, working eight hours a day, to complete the 205 bureaucratic steps—involving fifty-one different departments and bureaus—to get secure title.

In choosing to be informal, people give up the benefits of formal institutions established to facilitate commerce. They lose access to formal credit markets; to courts, which can enforce impersonal contracts; and to formal insurance institutions and pension benefits. De Soto even concluded that since the Peruvian government collects more than half of its tax revenues from informal sources, the informal sector pays more taxes than the formal sector in that country.

Beyond these specific conclusions and the policy recommendations they imply, de Soto's work has larger ideological and philosophical implications, which have changed the nature of the political debate in Peru and may do so in other places. He argues, for reasons analogous to a famous remark that Chesterton once made about Christianity, that the debate between "capitalism" and "socialism" has had no meaning in Peru. The problem, Chesterton said, was not that Christianity had been tried and found wanting, but that it had been found difficult and not tried. Despite claims to the contrary from all sides, de Soto argues, there has been almost no capitalism in Peru. Its bureaucratically protected private sector is *mercantilist*, not capitalist; the only real capitalists in the country, he concludes finally, are the informals and the poor.