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**Business strategies of informal  
micro-entrepreneurs in Lima,  
Peru**

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Valentina Zuin

International Institute for Labour Studies Geneva

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## **Abstract**

This paper presents the results of a field research on informal micro-entrepreneurs conducted in the Cono Norte of Lima, Peru. The research, based on semi-structured interviews, aims at understanding how micro-entrepreneurs develop their activities in a poor district in Lima, what problems they face in marketing their products and in accessing credit, and the strategies they adopt to overcome these problems. Additionally, this research aims to evaluate the degree of informality of micro-entrepreneurs in Lima, by collecting information on whether and why they are officially registered, have the required licenses to operate, pay taxes and respect regulations for their employees. Finally, this work aims at reflecting on which policies, if any, could facilitate the development of micro-enterprises and increase their degree of formality.

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## 1. Introduction

This paper presents the results of field research based on interviews with informal micro-entrepreneurs conducted in Lima, Peru between December 2001 and February 2002. The paper aims at understanding how micro-entrepreneurs develop their activities in a poor district in Lima, the problems they face in marketing their products and in accessing credit, and the strategies they adopt to overcome these problems. Additionally, this research aims at evaluating the degree of informality of micro-entrepreneurs in Lima, by collecting information on whether and why they are officially registered, have required licenses to operate, pay taxes and respect regulations for their employees. Finally, this work aims at reflecting on which policies, if any, could facilitate both the promotion of micro-enterprises and boosting formalization.

There are two main reasons why this field research focused on Peru. First, the percentage of informal employment in Peru is higher than in any other Latin American country except Honduras. Additionally, the percentage of employment in the informal sector in the country has been on the rise for at least a decade, increasing from 52,7% in 1991 to 59,5% in 2001 (OIT: 2002).<sup>1</sup>

Second, in Peru many sectors of the economy underwent a reform process when the newly elected president Alberto Fujimori came into power in the beginning of the 1990s. One of the first issues addressed by the new government was to provide a more adequate legal framework for micro and small enterprises to operate formally.<sup>2</sup> Following a proposal made by the Peruvian economist Hernando De Soto's think tank *Instituto Libertad y Democracia* (ILD), a Unified Business Register (*Registro Unico de Contribuyentes*, RUC) was established with the aim of simplifying the requirements and reducing the costs of conducting a formal business.<sup>3</sup> The previously existing system of multiple registrations at different institutions, in fact, was considered one of the main causes of the high cost to formalize, and was therefore replaced by the Unified Business Register. According to the ILD, the existence of this new government agency reduced "the red tape and costs dramatically: the nearly 300 days it took to obtain a business license were cut to one day - and one desk; the cost was slashed by seven times, from US\$ 1,200 to US\$ 174. Consequently, between 1991 and 1997 alone, 671,300 businesses were legalized" ([www.ild.org.pe](http://www.ild.org.pe)). In the following years a number of other reforms in the fiscal field were approved. In 1992 a fiscal reform introduced two tax regimes for micro enterprises with the goal of reducing the administrative costs and the fiscal burden on micro-businesses.<sup>4</sup> Several attempts at reform were also undertaken to reduce the bureaucratic obstacles and the costs for formal businesses imposed by municipal Governments.

The paper is organized as follows. Section 2 describes the methodology used during the field research. Section 3 provides some background information on the micro-entrepreneurs interviewed. Section 4 focuses on the empirical findings of the interviews of informal micro-entrepreneurs and, in particular, on the timing and reasons for entering into informal activities. Section 5 examines the types of clients micro-entrepreneurs supply, the reasons why they think clients buy from them, whether micro-entrepreneurs have problems in finding clients, and the strategies micro-entrepreneurs adopt to overcome these problems. Section 6 focuses on

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<sup>1</sup> Note that data refers to Lima and not to Peru, and that data on Bolivia are not available. The ILO definition of informal sector includes own-account workers, domestic workers and micro-enterprises with up to 5 workers. Professionals are excluded.

<sup>2</sup> A study made by Hernando De Soto (1989) provided clear evidence on the inadequacy of the Peruvian legal framework, and argued that informality is the refuge of individuals when the costs of obeying the law outweigh the benefits.

<sup>3</sup> The Unified Business Register has then been absorbed into the National Superintendence of Tax Administration (SUNAT).

<sup>4</sup> These are the *Règimen Unico Simplificado* (RUS) and *Règimen Especial del Impuesto a la Renta* (RER).

whether micro-entrepreneurs make use of credit and, if they do, what kind and at what stage of the development of their business. Particular relevance is given to bank credit. Section 7 concludes.

## 2. Methodology

The investigation was carried out between December 2001 and February 2002 in the Cono Norte district in Lima.<sup>5</sup> Informality represents an important issue in this area. During the 1940s, there was a heavy migration from Peruvian coastal and mountain regions to Lima, where industries were growing to support the import substitution policy. This migration primarily affected the Cono Norte district. Because of the already existing road *Panamericana Norte* connecting this area to the center of Lima, many firms settled in the Cono Norte. In the 1980s, the recession caused the closure of many of these firms. The impact on local labour demand was significant. So it was the impact on informal work.

This field research is based on 67 interviews conducted with informal micro-entrepreneurs and vendors.<sup>6</sup> Among these interviews, 26 were based on a questionnaire distributed to informal entrepreneurs in the Cono Norte district during a workshop organized by the *Centro de Asesoría a las Empresas (CEASE)* of the *Universidad Católica Sedes Sapientiae* in Lima.<sup>7</sup> The remaining 41 interviews were personally conducted using a semi-structured approach. In order to summarize responses, the answers given during the interviews were later classified according to the questionnaire we distributed at the workshop.

In the questionnaire, multiple answers to questions were provided. In the interviews, however, people were asked open-ended questions and, only when the person interviewed seemed to have difficulties in answering the questions, some options were given to initiate the discussion. Over the course of time we realized that open-ended questions provided the most sensitive and therefore interesting information, without making the respondents feel uncomfortable. Additionally, we also realized that respondents often volunteered further information about themselves and about their experiences, and enjoyed having people, especially foreign people, interested in their activities. On the other hand, closed questioning seemed to be unsuccessful. These are common findings in empirical research based on interviews touching upon sensitive issues. For instance, Bewley (1999, 2002) describes similar methodological issues in the context of interviews to business decision makers. He finds that “respondents were most informative when they talked freely and the discussion wandered” (1999: 16) and that closed questioning did not work because “the issues discussed were emotionally charged and respondents had certain things they wanted to say” (1999: 23).

Both the questionnaire and the interviews were based on the same structure and tried to address the following questions:

1. When and why respondents entered into informal activities.
2. Whether respondents have problems in finding clients and the strategies they adopt to expand sales.

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<sup>5</sup> The Cono Norte district is an area of 930 km<sup>2</sup> in the Northern part of Lima. It is made up of 9 Municipalities (Ancon, Carabaylo, Comas, Independencia, Los Olivos, Puente Piedra, San Martin de Porres, Santa Rosa, Ventanilla) and inhabited by the 25% (1,800,000 inhabitants) of the total population of Lima.

<sup>6</sup> Note that when we use the term “informal” we refer to a dynamic concept: within the informal sector we can distinguish different degrees of non-compliance with the legislation. Additionally, as reported in the 2002 ILO Report on Decent work and the Informal Economy, “formal and informal enterprises are not self-contained segments but rather part of a continuum” (ILO: 2002).

<sup>7</sup> During the workshop we personally helped the respondents to fill in the questionnaires by clarifying the questions.

3. Whether respondents comply with the fiscal law, i.e., whether they register in the Unified Business Register and hold a municipal license, and why they do or do not.
4. Whether respondents access credit, in particular bank credit; if they do, at which stage of their activity; if they do not, then why.

In the beginning of the project, informal micro-entrepreneurs and vendors were approached directly without any intermediary, but the information they provided was very general and therefore not satisfactory. This was foreseeable as respondents were asked to talk about sensitive issues. Additionally, since we did not give respondents any incentive to cooperate and they feared the consequences of giving information about their activities, they could have given us partial, inaccurate, or even false answers.<sup>8</sup>

In order to partially overcome these problems, we selected the people to interview with the help of some “key informants”<sup>9</sup> who directly knew or put us in contact with some informal or semi-formal micro-entrepreneurs and vendors. Our key informants belonged to the Commission for the Formalization of Real Estate (COFOPRI), the University “Sedes Sapientiae” and some Cooperatives. Moreover, when interviews took place in markets or small neighborhoods, we asked the “permission” of the market or neighborhood “representative”.<sup>10</sup> Representatives, in fact, were always very helpful in suggesting whom to interview or in recommending us to them.

Two factors were essential for obtaining interesting information, especially regarding the most sensitive issues. First, being accompanied or recommended by people the respondents knew. This facilitated the building of trust and made the respondents more open to provide detailed answers to our questions. The second factor allowing us to obtain interesting information was to avoid asking questions which could have made respondents feel uncomfortable such as, for example, regarding earnings, expenses, the level of education and the legality of their activities.

Although respondents were selected regardless of the activity they were conducting, we tried to interview people involved in trade, production and transport services in order to have a better understanding of the different activities carried out by informal workers. Additionally, we always interviewed the person responsible for the business. This is both because they obviously have a greater knowledge of the way the activity works and also because we experienced that workers did not dare giving information about the business without the employer’s permission, as they feared to lose their jobs.<sup>11</sup>

We decided to interview as many people as it was necessary to hear “sounded and repetitive answers and be confident of the pattern seen” (Bewley 1999: 22). It is interesting to point out that the answers given by people working in similar circumstances or activities were quite uniform. The uniformity of the answers therefore allows one to overcome some limits posed by the small size of the sample and to generalize the results to other informal workers in similar circumstances (Bewley 2002: 349). However, as Bewley notes referring to his field research, “it is impossible to say whether the uniformity is due to the logic of the circumstances or to the culture of the business community or of particular industries” (2002: 348).

The interviews lasted from a minimum of half an hour to a maximum of two hours, depending on the person and the time he or she was able to dedicate to us. Moreover, as only few of the people interviewed had a phone, it was not possible to arrange an appointment in

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<sup>8</sup> This is a problem that field research always has, however it increases if the information requested are confidential or if the issues are delicate.

<sup>9</sup> According to the definition given by Bewley (2002: 345), key informants are “people in critical institutions or that are very knowledgeable about the topic studied”.

<sup>10</sup> People working in markets or living in neighborhoods, especially if undergoing the formalization process of the real estates, are often represented by some “managers”, who are considered the persons to make reference to in the local community.

<sup>11</sup> Employees’ fear to loose their job also made it impossible for us to obtain information regarding employers’ compliance with labour law.

advance. Note also that it was not possible to re-contact the same people to obtain further clarification.

The interviews were carried out at the respondents' workplace. This was important as it allowed us to observe the enterprises and the respondents' relationship with other clients and vendors. However, it had the disadvantage that we were interrupted when respondents had to attend to clients.

We did not take many notes during the interviews nor used a tape recorder. This is because taking notes or recording would have limited the amount and the detail of information provided by the respondents, especially regarding the most sensitive issues. However, after each interview, we wrote down all the information collected and classified it in the questionnaire.

In order to have a better understanding of the information provided by the respondents, it was also very important to interview the "key informants" themselves. We therefore interviewed some public officers of the Municipalities of the Cono Norte "*Los Olivos*" and "*Independencia*", two managers of street vendors associations, two managers of credit cooperatives and two managers of semi-formal *Centros Comerciales*. Finally, the Director of the field activities of the Commission for the Formalization of Real Estate (COFOPRI) and four collaborators were also interviewed.<sup>12</sup> Note that sometimes key informants accompanied us during the interviews. This was particularly useful in enabling us to better understand certain issues discussed with the respondents.

For all its merits, the methodology described above has a number of limits, as is well discussed by Bewley (1999, 2002). First, the sample analyzed is necessarily quite small. According to Bewley (2002: 349), however, "uniformity of behavior in similar circumstances" reduces "the need for a representative random sample". Second, the sample is not random. It depends on the way people interviewed are selected as "a sample obtained through friends and acquaintances is hardly random" (Bewley 1999: 16). In fact, respondents belonging to the same networks, either because they know each other or work in the same area or conditions, are more likely to give uniform answers. According to Bewley (1999: 16), however, in fieldwork there is "a trade-off between the randomness of a sample and the quality of the interviews". Finally, information collected through open-ended interviews is more difficult to organize and present. For all these reasons, data were not analyzed with statistical methods. Results, instead, are presented in tables, showing the frequency with which each answer was given and, where useful, through quotations.

Despite these limits, this method of selecting people and conducting in-depth interviews had two main advantages. First, it permitted the collection of first-hand, detailed and sensitive information. Second, it allowed us to get a quite reliable sense of the respondents' degree of entrepreneurship. This second advantage is particularly important because – according to the respondents' entrepreneurship in conducting business, their ability to find clients and the profitability of their business – the people interviewed were classified into two categories:

- Those who are micro-entrepreneurs;
- Those who develop activities only with the aim of surviving.

According to our classification, micro-entrepreneurs are those who develop quite remunerative businesses and conduct not only commercial activities but are also involved in production or in both production and direct selling.<sup>13</sup> Additionally, although micro-entrepreneurs do not have enough resources to innovate and purchase advanced technologies,

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<sup>12</sup> The Commission for the Formalization of Real Estate Rights (COFOPRI) is a Governmental Institution created with the aim of formalizing the *pueblos jovenes* (squatter settlements) in Peru.

<sup>13</sup> Whenever a respondent involved only in trade was classified as micro-entrepreneur it is because his or her activity is entrepreneurial and profitable, for example because he (or she) is able to meet clients' needs or has a very well established commercial activity, and therefore cannot be considered a person with the aim only of surviving.

they are generally quite entrepreneurial, have a medium-term strategic vision and a quite developed organizational capacity. Moreover, thanks to their experience and effort, they are creative and able to access market opportunities and meet market demand.<sup>14</sup>

Those who develop survival activities, on the other hand, live hand to mouth and have limited planning and organizational abilities. They have no fixed capital and often use credit for working capital. They generally develop commercial activities because entry barriers are low and no special skills are needed. Their attitude is focused on survival and they are not growth oriented.

Note that both micro-enterprises and survival activities have the characteristics of units belonging to the informal sector as defined by the ILO. In fact, the informal sector has been described by the ILO as follows:

“Units engaged in the production of goods or services with the primary objective of generating employment and incomes to the persons concerned. These units typically operate at a low level of organization, with little or no division between labour and capital as factors of production and on a small scale. Labour relations - where they exist - are based mostly on casual employment, kinship or personal and social relations rather than contractual arrangements with formal guarantees. Production units of the informal sector have the characteristic features of household enterprises. The fixed and other assets used do not belong to the production units as such but to their owners. The units as such cannot engage in transactions or enter into contracts with other units, nor incur liabilities, on their own behalf. [...] Expenditure for production is often indistinguishable from household expenditure. [...] Activities performed by production units of the informal sector are not necessarily performed with the deliberate intention of evading the payment of taxes or social security contributions, or infringing labour or other legislations or administrative provisions [...]”. (ILO, Fifteenth International Conference of Labour Statisticians, Resolution concerning Statistics of employment in the Informal Sector, 1993).

Within the informal sector, we have therefore made a distinction between micro-entrepreneurs and those who develop survival activities. Note however that this distinction does not imply that each category is mutually exclusive and that there is not always a clear cut distinction between the two.<sup>15</sup>

Of the 67 respondents in our sample, twenty-three were classified as micro-entrepreneurs and forty-four as informal workers who develop their activities only with the aim of surviving.

In this paper we will focus on micro-entrepreneurs and present our findings only regarding respondents classified in this category. Note that micro-entrepreneurs do not represent the majority of those who work informally nor the majority of our respondents. Still, there are reasons to focus on micro-entrepreneurs. First, while those who develop survival activities cannot afford to become formal, micro-entrepreneurs often manage to be profitable and can – and to some extent do – formalize their activities. One aim of our research is therefore to understand whether and why they are formal or informal in certain aspects of their activities. Second, micro-entrepreneurs might have potential for generating employment and fostering growth at the local level. It is therefore interesting to understand how they develop their activities and what policies, if any, could aim at both the development of micro-enterprises and increasing their degree of formality.

We now move on presenting the characteristics of the twenty-three respondents who were classified as micro-entrepreneurs. We will then present the findings of our field research.

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<sup>14</sup> This classification considers micro-entrepreneurs both those who have employees and those who are self employed if they develop entrepreneurial activities. Note also that, differing from the De Soto (1989), we do not consider entrepreneurs all those working in the informal sector.

<sup>15</sup> Some businesses have some characteristics of both survival and entrepreneurial activities: in these cases it was our personal impression that guided the classification into one or the other category.

### 3. Overview of the characteristics of the micro-entrepreneurs interviewed

This section provides some background information on the micro-entrepreneurs interviewed, including sex and age of the employer, dimension and location of the enterprise, type of business, division of labour within the enterprise, and the role of family members in the activity.

Of the twenty-three micro-entrepreneurs, nineteen were interviewed, while four filled in the questionnaire.

Of the twenty-three micro-entrepreneurs, fourteen are men and nine are women, all between 30 and 50 years of age. Five are own-account workers and eighteen are employers in small firms, with a maximum of nine employees. Table 1 shows the distribution of micro-entrepreneurs interviewed by firm size, with a breakdown by gender.

**Table 1: Micro-entrepreneurs by gender and firm size (n=23)**

	Number of employees	Employer	
		Male	Female
<b>Self-employed</b>	-----	2	3
<b>Small firms</b>	1	3	0
	2	1	1
	3	2	2
	4	3	0
	5	1	0
	9	2	2
	Variable	0	1
<b>Total</b>		<b>14</b>	<b>9</b>

As shown in table 1, twelve micro-entrepreneurs have between 1 and 4 employees, one has 5 employees and four have nine employees. Of these four, two are men and two are women. The two businesses run by women are cooperatives. Note that six micro-entrepreneurs volunteered the information that the number of workers employed declared in the interview actually varies according to the season, the economic situation and the orders received from clients (in one case no information was provided on the current number of workers because of high variability).

Table 2 shows the type of activity conducted by the respondents with a breakdown by gender.

**Table 2: Type of activity (n=23)**

Type of activity	Number of enterprises	Male	Female
Production and trade	17	10	7
Trade	4	2	2
Taxi drivers	2	2	0
<b>Total</b>	<b>23</b>	<b>14</b>	<b>9</b>

As shown in table 2, seventeen micro-entrepreneurs run businesses which entail both production and trade activities (ten men and seven women). Among them, five are artisans, four are producers and traders of bags and cases for different items, three are producers and traders of clothes, three are producers and traders of shoes or shoes accessories, and two are carpenters.

Four micro-entrepreneurs are involved in trade activities (two men and two women): two are traders of shoes and shoes accessories, one of clothes and one sells perfumes and bags. The remaining two are taxi drivers (both men).

Table 3 shows the location of the activity with a breakdown by gender.

**Table 3: Location of the activity (n=23)**

Location	Number of enterprises	Male	Female
Market	9	5	4
Home	10	5	5
Taxi	2	2	0
Not available	2	2	0
<b>Total</b>	<b>23</b>	<b>14</b>	<b>9</b>

As shown in table 3, nine micro-entrepreneurs work in a market (five men and four women). Among these, four work in the “Caquetà” market, which is the most well known place in Lima to buy shoe accessories and shoes. This is why many micro-entrepreneurs are involved in activities related to the production or trade of these items. The remaining five work in non-specialized markets, serving only clients within the immediate neighborhood. Ten micro-entrepreneurs work at home (five men and five women) in poor households located in the districts of *Los Olivos*, *Independencia*, *San Martin de Porres* and *Comas*. Finally, two (men) do not have a fixed location as they are taxi drivers and in two cases location is not available, as the respondents filled in the questionnaire and did not provide the information. Note that some of those who work in a market are also involved in production activities. Some of them in fact sell their own products in the market, which they produce at home or while selling at the market.

In order to see whether the division of labour within micro-enterprises is consistent with the definition of informal enterprises given by the ILO, micro-entrepreneurs were asked about their assignments within the enterprise. Table 4 shows the distribution of answers with a breakdown by type of business (trade only, production and trade, taxi drivers). Note that numbers in columns 3-6 do not add up to 23 (the total number of entrepreneurs interviewed) because of the possibility of multiple answers.

**Table 4: Assignments carried on by micro-entrepreneurs with a breakdown by type of business (n=23; multiple responses possible)**

Type of business	Number of micro-entrepreneurs	Management	Production	Distribution	Purchase of inputs
Trade	4	4	-----	4	4
Production and trade	17	17	10	16	13
Taxi drivers	2	-----	-----	-----	-----

As shown in line 2 of table 4, all four micro-entrepreneurs involved in trade are responsible for all their activities: management, distribution and purchase of inputs.

In the case of businesses involving both production and trade activities, all seventeen micro-entrepreneurs are responsible for the management of the activity and sixteen are also responsible for distribution. Micro-entrepreneurs indicated that they prefer to be directly in charge of distribution because they fear that their employees could take advantage of contacts established with clients by opening a new business and taking away their clients. This is confirmed by the fact that in the only case where the owner is not in charge of distribution, his

family members are, and he volunteered the information that he would not trust any person other than a member of the family.

Among the seventeen micro-entrepreneurs running production and trade activities, thirteen directly purchase inputs. This is related to the fact that micro-entrepreneurs are in direct contact with clients, and therefore know the quality and characteristics of the product requested by their clients. Additionally, micro-entrepreneurs do not trust employees to buy for them because micro-entrepreneurs have their own suppliers and have established a personal relationship with them. Of the same group of micro-entrepreneurs, only ten are also involved in production. This lower number indicates that if some division of labor exists in micro-enterprises, it takes place in the production process. Finally, note that the division of labour does not apply to the two micro-entrepreneurs working in transport services (taxi drivers).

In conclusion, in the micro-enterprises considered there is little or no division of labour, since most micro-entrepreneurs, regardless of the activity they run, are responsible for management as well as for distribution, purchases of inputs, and production. This limited division of labour is consistent with the characteristics of informal enterprises as defined by the ILO.

In order to understand whether family members have an important role in the business, as stated in the definition of informal enterprise given by the ILO, micro-entrepreneurs were also asked whether they employ family members, and if they do, how many. Table 5 shows the number and percentage of family workers in each category of enterprise. Note that only 17 enterprises are considered, as five micro-entrepreneurs are self-employed.

**Table 5: Family workers in each category of enterprise**

	Number of employees in each firm	Number of enterprises in each category	Number of family workers in each category	% Family workers
<b>Total</b>		<b>17</b>	<b>30</b>	<b>40,3%</b>
<b>Small firms</b>	1	3	2	66,7%
	2	2	1	25%
	3	4	6	50%
	4	3	12	100%
	5	1	2	40%
	9	4	7	19,4%
	Variable	1		-----

As shown in table 5, family members often work within the family business, especially if the enterprise is small. This is confirmed by the high overall share (40,3%) of family workers in the total number of employees employed by the seventeen firms considered. Only in the biggest enterprises do family members represent less than 20% of the total number of employees. The fact that family workers have an important role in the business is also consistent with the characteristics of informal enterprises as defined by the ILO.

The importance of the family in economic activities is made clear also by information provided by some of the micro-entrepreneurs interviewed. Family members, in fact, often collaborate at different stages of the production process or at the selling phase. For instance, a micro-entrepreneur who produces cases for cellular phones and for home entertainment said, "My wife cuts the plastic in pieces, while my sons glue the pieces. I mainly supervise the production process and look for clients". Another micro-entrepreneur working in Caquetà market said, "While I am here at the market selling and receiving orders from clients, my sons work at home. Sometimes my older son comes here to help me". A man producing pieces of

furniture at home said, "I take care of the distribution of the pieces of furniture we produce, but it is my father who keeps contacts with clients".

Micro-entrepreneurs explain the high involvement of family members in their businesses by stating that family members need to help each other due to high rate of unemployment and the difficulties in finding a stable job. For instance, a micro-entrepreneur producing cases for cellular phones and for home entertainment said, "When people of my family are unemployed, they come and work for me. Three of them have been employed in my enterprise for the last two years".

Three major advantages of involving family members were indicated by micro-entrepreneurs. The first is the ability to benefit from "cost sharing". Micro-entrepreneurs, in fact, provided the information that they sometimes centralize purchases, share the location of production with other family members or supply each other with services. A vendor in Caquetà market said, "I cannot afford to buy market space by myself. It is too expensive. My brother-in-law and I decided to share it. We both pay half of the price and share the expenses". Another vendor stated that "Since in our family we are involved in the same business, we all buy together and we obtain better conditions".

A second advantage micro-entrepreneurs see in involving family members is the possibility to rely on unpaid family labour. For instance a micro-entrepreneur producing cases for cellular phones and for home entertainment said, "I prefer to rely on the help of my wife and other family members than to hire the most likely to be unpaid and help when free from other activities (such as going to school, street vending, etc.). A producer of pullovers said, "My children go to university, but whenever they have time they help me".

A third advantage in hiring members of the family is that micro-entrepreneurs can benefit from labour flexibility in the face of demand variation. Family members, in fact, can be asked to work temporarily or seasonally, if necessary. A woman producing bags and cases at home said, "If I have a lot of work, I ask my husband and my daughter-in-law to help me".

However, some micro-entrepreneurs also point out that working with family members may have disadvantages. They stated that mixing family and working relationships can be risky and lead to the failure of the business. A producer of pullover said, "Sometimes it can be dangerous to work with other members of the family. I had a fight with my sister and I quit working with her".

We now move on presenting the main findings of the interviews. First we will analyze when and why micro-entrepreneurs started their current activities. We then present data on the type of clients micro-entrepreneurs supply, their difficulties in finding clients and their strategies to reduce these difficulties. Finally, we consider whether micro-entrepreneurs access credit, in particular bank credit, and if they make large use of credit.

#### **4. Entering into informal activities**

Micro-entrepreneurs were asked when and why they started their current activities in order to understand whether the difficult economic and political situation of the end of the 1980s and the beginning of the 1990s had an influence on their decision to enter into an informal activity. Table 6 shows the distribution of answers.

**Table 6: Year business started (n=23) with a breakdown by gender.**

Year business started	Male	Female	Total	% of answers
Between 1996 and 2001	1	2	3	13%
Between 1990 and 1995	5	4	9	39,1%
Between 1985 and 1990	6	1	7	30,4%
Before 1985	2	0	2	8,7%
Not available	0	2	2	8,7%

As shown in table 6, the majority of micro-entrepreneurs started their current activity in the late 1980s or the early 1990s. In particular, seven (30.4%) (six men and one woman) started their current activity between 1985 and 1990 and nine (39.1%) (five men and four women) between 1990 and 1995. Three (13%) entered their activity between 1996 and 2001 and two (8.7%) started their activity before 1985. In most cases this was not their first job experience, as is confirmed by information volunteered by many micro-entrepreneurs on their previous activity.

Seven micro-entrepreneurs volunteered the information that they migrated to Lima between the late-1980s and mid-1990s to find a job or to escape from terrorism. A vendor in Caquetà market said, "I knew that some cousins of mine moved to Lima, started their own business and made good profits. That is why I came in 1992. I wanted to find a job".

Ten micro-entrepreneurs explained that in the late 1980s and in the early 1990s, it was hard to find wage employment in formal firms and that many people lost their previous job because of the economic crisis, entailing hyperinflation, high unemployment and terrorism. A lady selling perfumes and bags in a market said:

"At the end of the Garcia Presidency when Fujimori came into power, the situation was really difficult because one day you had 100 soles and the day after it was as if you did not have anything. As soon as I earned some money I bought something, just to make sure not to lose my money. The political situation was also very unstable because the State was weak and mistrusted: "Sendero Luminoso" was governing".<sup>16</sup>

Of these ten micro-entrepreneurs, five said that they lost their wage employment during the crisis. A shoemaker said, "In those years many firms closed down. The firm where I used to work also closed. Everyday the economic situation was getting worse. Everyday firms were closing down and people had to start selling in the street in order to survive".

Micro-entrepreneurs were then asked why they started their current activity. Their answers confirm that the economic crisis of the late 1980s and early 1990s was a reason for many to set up informal activities. Table 7 shows the distribution of answers among the twenty-three micro-entrepreneurs interviewed with a breakdown by gender.

**Table 7: Reason to begin activity (n=23; multiple answers possible)**

<sup>16</sup> The Communist party of Peru Sendero Luminoso, which then became a group of terrorists, was created by a University professor from Ayacucho, Guzman, in the beginning of the 1980s. The party was run by young educated people of peasant origins and had the support of the peasants in the countryside who were asking for agrarian reforms to the State. These reforms, however, were not passed and the tension in the peasants communities increased as well as the opposition to the State, which was accused of unwillingness to improve the conditions of the poor. In this political context, made worse by the economic crisis of these years, Sendero Luminoso became very strong at the local level, first in the countryside and then in Lima, and often substituted the State itself. At first, Sendero Luminoso seemed to give answers to many problems peasants had, but violence progressively increased and people started being forced to support the party. Only in 1992, when Fujimori's government finally arrested Guzman, the level of violence and political tension started decreasing.

Reasons	Males	Females	Number of answers	% of answers
No other choice	8	3	11	47,8%
Family tradition	9	1	10	43,5%
Opportunity	0	4	4	17,4%
Profitability	2	0	2	8,7%
Other reasons	1	1	2	8,7%
Self-fulfillment	0	1	1	4,3%

As shown in table 7, eleven (48%) respondents started their business because they had no other option and ten (43%) because they took over a family business or started a new activity in the same sector as other family members. Note that since answers are not mutually exclusive, of those who had no other option, roughly one third took over a family business or started a new activity in the same sector as other family members. A micro-entrepreneur producing pullovers said, "When I lost my job I did not know what to do, but I thought that I could have joined my sister in her activity". Two volunteered the information that they decided to start a business in the same sector in which they previously worked. A vendor in Caquetà market said, "All my family is dedicated to this activity. I thought to do it as well as I already know how to run this kind business and experience is important". On the other hand, only three (13%) respondents began their businesses for its profitability or for self-fulfillment.

Regarding gender breakdowns, nine men took over a family business or started a new activity in the same sector as other family members and eight began their activity because they had no other option. Of those who had no other option, half volunteered the information that they were previously in wage-employment and began their activity when they lost their job. A shoemaker working in a market said, "I had a job here in the Cono Norte, but the firm closed down because of the crisis. I could not find another job and for this reason I started working informally".

Among women, four began their activity because they had the opportunity to do so (throughout public programs, friends' proposals, and community-based activities), and three had no other option. Three women volunteered the information that they began their activity when their husbands lost their jobs. A woman selling bags in a market said, "What should I have done? I lost my job and my husband did as well. We have three kids and we have to survive". Only one woman said that she was previously employed in a firm. However, women were often previously involved in home-based activities. Five volunteered the information that they were involved in community-based activities or worked at home selling food or other hand-made items. A woman producing bags at home said: "I always tried to earn some money, just preparing *cebiche* or *tamales* and selling them in the neighbourhood.<sup>17</sup> However, I mainly worked at home because I had to take care of my children and the house. My husband was the one who worked". Another woman said, "For a period I was cooking everyday in a *comedor popular*.<sup>18</sup> We were many women, all volunteering in the community. Now I do not have time anymore."

Note that although when micro-entrepreneurs started their activity they did not seem to have many other options, they volunteered some interesting information regarding the reasons why they continue their current informal activities and do not look for a formal job. Eight

<sup>17</sup> These are typical Peruvian dishes made of uncooked fish marinated in lemon juice (*cebiche*) and of corn and meat (*tamales*).

<sup>18</sup> Communal refectory at the neighborhood level, managed by women who cook for the people living in the neighborhood. In this way woman who work do not have to worry about preparing lunch for their families and even who cannot afford a kitchen will be able to have decorous meals paying only a small amount of money.

micro-entrepreneurs said that their current activity is more profitable than their previous wage employment. Another eight mentioned that they do not want to go back to wage employment or look for wage employment because their current activity allows them to be more independent, even though it is more unstable. This suggests that although in most cases informality is a need, especially at the beginning, micro-entrepreneurs sometimes consider informal employment a desirable alternative to formal employment.<sup>19</sup>

In sum, there seems to be a relationship between the economic and political crisis of the late 1980s and early 1990s and the entrance into micro-entrepreneurial activity. This is in line with the observation made by other authors that the informal sector acts as a macroeconomic buffer over business cycles.<sup>20</sup> Additionally, although some micro-entrepreneurs consider informality a desirable alternative, in that it allows them to earn higher profits and be independent, our observations support the hypothesis that informality, at least in the beginning, is more involuntary than voluntary in nature.<sup>21</sup> In fact, in the case of males, the loss of wage employment during the economic crisis and the migration from the rural areas seem to be the most important reasons why people started their informal activities. Women, instead, tend to be in their first work experience in a micro-entrepreneurial activity, although in many cases they have previous experience in home-based small survival activities. In a significant number of cases, women entered into their current activity when their husband lost his job. In other words, for both men and women the setting up of a small business was often a response to a necessity, when the family breadwinners lost their wage employment.

## 5. Finding clients

In this section we analyze the type of clients micro-entrepreneurs supply, the reasons why they think clients buy from them, and whether micro-entrepreneurs have problems in finding clients. We then investigate which strategies they adopt to overcome their difficulties in finding clients. In particular, we focus on whether micro-entrepreneurs use a price strategy and an advertising strategy to attract clients and whether these strategies are successful. Finally, we present the three ways most commonly used by micro-entrepreneurs to find clients: word-of-mouth advertising, door-to-door selling and partial formalization of their business.

### a) Type of clients and factors attracting clients

We now turn to the type of clients micro-entrepreneurs supply. Micro-entrepreneurs were asked whether they supply final consumers, enterprises or wholesalers. Table 8 shows the distribution of answers.

**Table 8: Type of clients (n=23; multiple answers possible)**

<sup>19</sup> This was also found by Maloney (1998, 1999) for Mexico.

<sup>20</sup> For a detailed literature survey on the informal sector as a buffer over business cycles see Galli and Kucera (2003: 10).

<sup>21</sup> There are many authors that refer to informality as being involuntary. For example see De Soto (1989).

Type of clients	Number of answers	% of answers
Final clients	17	73,9%
Other enterprises	10	43,5%
Wholesaler	6	26,1%
Not available	2	8,7%

As shown in table 8, 17 (73,9%) micro-entrepreneurs supply final consumers, ten (43,5%) supply other small enterprises and six (26,1%) micro-entrepreneurs supply wholesaler (in two cases answers are not available).

Micro-entrepreneurs were then asked the reasons why they think clients buy from them. Table 9 shows the distribution of answers.

**Table 9: Why do you think clients buy from you? (n=23; multiple answers possible)**

Reasons	Number of answers	% of answers
They know me	16	69,6%
Production to order	12	52,2%
Quality	8	34,8%
Good location	7	30,4%
Only producer/vendor of the item	5	21,7%
Punctuality	3	13%
Long opening hours	3	13%
Courtesy	2	8,7%
Able to supply a high demand	2	8,7%
Low price	2	8,7%

As shown in table 9, sixteen (69,6%) micro-entrepreneurs think that clients buy from them because they directly know the micro-entrepreneur. A micro-entrepreneur producing pieces of furniture at home said, “My clients trust me and know that I do a good job. Some other clients of mine recommended me to them”. A producer of pullovers and garments said, “In Gamarra<sup>22</sup> I am well known. I have been doing this work for a long time and they know me as I go there to sell at least once a week”. Thus, social networks seem to be considered by micro-entrepreneurs as the main factor influencing clients’ decisions.

Twelve micro-entrepreneurs (52,2%) believe that clients choose them because they produce to order. A producer of garments said, “I take some samples and my clients choose the model and the color they want”. An artisan said, “Whatever clients ask, we produce”. This suggests that micro-entrepreneurs believe it is very important to be able to satisfy clients’ specific needs.

Eight (34,8%) micro-entrepreneurs name quality as one of the main reasons clients buy from them. It may seem surprising that micro-entrepreneurs believe quality being such an important factor for clients. Clients, in fact, are often poor and therefore one might think that they would mainly take into consideration price when purchasing. However, only two (8,7%) micro-entrepreneurs believe that clients buy from them because of their price. This could suggest that competition is high and therefore prices are very similar for similar products, so that clients take into consideration other factors than price when purchasing.

<sup>22</sup> Gamarra is a garment district, which represents 60% of Peru’s textile market. There are 14000 small business and 6000 people employed (data from [www.ashoka.org](http://www.ashoka.org)).

In seven (30,4%) cases micro-entrepreneurs also indicated location as a reason to be chosen by clients. Among these, four work in a market, one is a taxi driver, and one works at home (for one location is not available<sup>23</sup>). Only five (21,7%) micro-entrepreneurs indicate that they are the only producers or vendors of the item in the area. This also suggests that competition is high. Finally, three (13%) micro-entrepreneurs named long opening hours for clients to make purchases and three others punctuality as the main factors influencing clients' decisions. Two (8,7%) said that clients buy from them because they are able to supply high demand and other two (8,7%) because of their courtesy.

Summing up, the majority of micro-entrepreneurs think that clients buy from them because they directly know the micro-entrepreneur and because they produce to order. Price, in contrast, is not considered by micro-entrepreneurs as a major factor influencing clients' decisions and other factors, such as quality and location, seem to be more relevant.

### **b) Is finding clients a problem?**

Micro-entrepreneurs were asked whether finding clients and distribution channels is a problem for them. Many authors, in fact, consider informality a major obstacle to access markets.<sup>24</sup> Table 10 shows the distribution of answers with a breakdown by location and by instability of earnings.

**Table 10: Is finding clients a problem?**

	No. of answers	% of answers	Location				Are earnings unstable?			
			Market	Home	Taxi	Not available	Yes	No	Sometimes	Not available
<b>Yes</b>	12	52,2%	3	7	0	2	7	2	1	2
<b>No</b>	9	39,1%	6	1	2	0	1	3	1	4
<b>It depends</b>	2	8,7%	0	2	0	0	1	0	1	0

As shown in table 10, finding clients is a problem for twelve (52,2%) micro-entrepreneurs. Among them, seven work at home, three in a market and for two location is not available. Of these twelve, seven face instability of earnings. This suggests that the problem of finding clients is relevant for those who work at home, as expected, and it is also closely related to instability of earnings.

Nine (39,1%) micro-entrepreneurs, in contrast, do not consider finding clients a problem. Note, however, that six of them work in a market and other two are taxi drivers, and therefore they do not suffer from lack of visibility. Moreover, among these nine, only one consistently faces instability of earnings.

Finally, two (8,7%) micro-entrepreneurs have problems in finding clients depending on the economic situation and the season. For instance, a woman producing garments and school uniforms said, "At the beginning of the school year and during Christmas time I do not have problems in finding clients, but it is very difficult in other periods of the year". A micro-entrepreneur producing cases for cellular phones and for home entertainment said, "At

<sup>23</sup> This is the case of a micro-entrepreneur who filled in the questionnaire and who did not specify the location of his activity.

<sup>24</sup> For instance, according to Maldonado's field research in Bogotá (1997: 50) market access is perceived as the most important problem for 29% of the interviewed, while 36,8% considered credit access as the most important problem. Morrisson et al. (1994) also find that unstable or inadequate demand and financing problems are always the biggest obstacles micro-entrepreneurs face.

the moment the markets are quite stagnant in Chile and Argentina and also in Peru the situation is quite tough. But if I get a big order, everything will change”.

Regarding instability of earnings, note that ten micro-entrepreneurs (58,8%) volunteered the information that because of the instability of earnings, they can only hire workers temporarily and if they receive an order from clients. Another micro-entrepreneur producing pullovers and articles of clothing said, “Sometimes I really need workers, sometimes I do not. There are periods where I have a lot of work, such as Christmas and when school starts, and periods where there is no work”. A micro-entrepreneur said, “Workers pass by and ask for work. Sometimes I have a lot of work. Two years ago I had periods when I was employing 35 workers, but now the situation is not so good”. A woman producing cases and bags and working in a market said, “There are people coming to look for work to do every day. When I have work, I give some to them, but at this time of the year the situation is quiet”<sup>25</sup>.

Summing up, finding clients is a problem for the majority of micro-entrepreneurs and it is more likely to affect those who work at home. Moreover, the instability of earnings tends to be linked with difficulties in finding clients and affects labor relationships, in that micro-entrepreneurs cannot guarantee stability to their employees.

### **c) Strategies to expand sales**

#### **a) Pricing strategy**

In order to expand their sales, micro-entrepreneurs could either reduce the price of their products or increase advertisement and therefore visibility of their products.

Price reduction is an option only if costs can be reduced or if competition is not too high so that mark up on costs can be lowered without jeopardizing the survival of the activity and of the micro-entrepreneurs themselves. Some information volunteered by micro-entrepreneurs about the way they set prices suggests that competition is very high. Fifteen micro-entrepreneurs, in fact, stated that they could not afford to lower their prices as they would go out of business. Six micro-entrepreneurs, all working in markets and involved in trade, volunteered the information that they face direct competition from other vendors in the market and therefore have to set the price according to their competitors. If not, they would lose clients. For example a micro-entrepreneur selling shoes and shoe accessories in Caquetà said, “How can I make the price different from the others? We work in the same place and sell similar products, clients would just go to the vendor who is selling in front of me”. This also shows that products are undifferentiated, making competition even greater.

Also micro-entrepreneurs who work at home, even if they do not face direct competition from other vendors, cannot set prices independently. Nine micro-entrepreneurs, in fact, volunteered the information that there is a customary price for certain items, i.e. a common understanding of an appropriate price among clients and vendors, and that if they do not take it into account they would go out of business and lose clients’ trust. For instance an artisan said, “Everybody knows that the price of a small bag is 10 soles. If I sell it for more I will not find anyone who buys it”. Another micro-entrepreneur said, “What if my clients discover that they can find the same products at a lower price? They will not trust me anymore and they would not recommend me to anyone”.

Finally, micro-entrepreneurs also declared that it is difficult for them to lower their costs as they have the same suppliers of the others working in the market. For instance, a micro-entrepreneur working in Caquetà said, “Suppliers come here to sell and we all buy for the same price. That is why it is not possible for me to lower my costs”.

<sup>25</sup> She refers to the period after Christmas, when the interview took place.

Summing up, it is very unlikely that micro-entrepreneurs could afford to expand their market shares by lowering their markup on costs because competition is very high and profitability very low. Similarly limited appears the possibility to lower prices by reducing costs. The viability of their activities seem therefore to be related to micro-entrepreneurs' ability to establish trust and long-term relationships with clients and suppliers.

### b) Advertising Strategy

Another strategy that micro-entrepreneurs could adopt to expand their sales is to increase visibility of their products through advertising.

In order to understand how informal micro-entrepreneurs combine their need of finding clients with their necessity of remaining "invisible", micro-entrepreneurs were asked whether they publicize their activity through visiting cards, leaflets, posters, shop signs or through their participation in fairs and expositions. Table 11 shows the distribution of answers with a breakdown by location and type of activity.

**Table 11: Do you make publicity for your business (n=23)**

Type of publicity	No. of answers	% of answers	Location				Type of activity		
			Market	Home	Taxi	Not available	Trade	Production and trade	Taxi drivers
No	11	47,8%	6	5	0	0	4	7	0
Yes	12	52,2%	3	5	2	2	0	10	2
Visiting card or leaflets	9	39,1%	2	4	2	1	0	7	2
Posters	1	4,3%	0	0	0	1	0	1	0
Fairs/expositions	2	8,7%	1	1	0	0	0	2	0
Shop signs	0	-----	-----	-----	-----	-----	-----	-----	-----

As shown in table 11, almost half micro-entrepreneurs (47,8%) do not advertise their activity through visiting cards, leaflets, posters, shop signs or through their participation in fairs and expositions. Of these eleven micro-entrepreneurs, six work in a market and five work at home. Additionally, four work in trade and seven work in production and trade.

On the other hand, however, twelve (52,2%) micro-entrepreneurs state that they publicize their activities. Among them, nine use visiting cards or leaflets. This is the most widespread way of advertising both because it is relatively cheap and because it increases the possibility of expanding sales without increasing visibility. A micro-entrepreneur producing cases for different items said, "I distribute my cards in markets and I talk with the people to whom I give the card". Among those who advertise, two micro-entrepreneurs participate in fairs and exhibitions. An artisan said, "Last year there was this big international fair for craftsmen and I went as I wanted to make some new contacts especially with clients abroad". Only one uses posters. All micro-entrepreneurs who advertise their products are involved in production and trade or in transport services. Only three of them work in market, while the others work at home or are taxi drivers.

It is noteworthy that none of the micro-entrepreneurs interviewed has a shop sign. Also taking into account that only one micro-entrepreneur has a poster, it seems that the main way micro-entrepreneurs publicize their activity is through leaflets and visiting cards. This suggests the fact that informal micro-entrepreneurs fear becoming more detectable and therefore avoid any kind of advertising that could increase their risks of being caught by public authorities.

However it is also interesting to point out that three micro-entrepreneurs said that increasing their visibility through posters or shop signs would not increase their sales because they are located in economically decentralized areas. For instance, a micro-entrepreneur producing crafts said, “No one passes by to purchase here. Clients come only if they already know who you are. Here in the neighborhood people know my business. There is no need to put up a sign”. Additionally, one volunteered the information that increasing visibility has the side effect of being more exposed to robberies. An artisan said, “When the activity was going well we had a sign, but we were robbed of all our machines. Now we are not going to put any sign anymore, it is too dangerous”.

Summing up, slightly more than half micro-entrepreneurs advertise their activity through visiting cards, leaflets, posters, or through their participation in fairs and expositions. The majority use leaflets and visiting cards while only one uses posters and none use shop signs. Less than half micro-entrepreneurs, on the other hand, declared that they do not use these means of advertising.

Note that when micro-entrepreneurs were asked whether they publicize their products, even those who do not advertise their activity through visiting cards, leaflets, posters, shop signs or through their participation in fairs and expositions volunteered interesting information about the way they find clients. Table 12 shows the information volunteered by micro-entrepreneurs with a breakdown by location and type of activity. Note that answers add up to 23 although respondents could give multiple answers and three of them answered that they do not make use of any kind of publicity, not even of word-of-mouth or door-to-door advertising.

**Table 12: Alternative means of advertising the activity (n=23; multiple answers possible)**

	Number of answers	% of answers	Location				Type of activity		
			Market	Home	Taxi	Not available	Trade	Production and trade	Transport services
<b>Word-of-mouth advertising</b>	13	6,5%	4	8	1	0	1	11	1
<b>Door to door</b>	10	43,5%	1	7	1	1		9	1

As shown in table 12, thirteen (56,5%) micro-entrepreneurs use word-of-mouth advertising. A shoemaker working in a market said, “Everybody in the market knows me. If someone needs shoes, he comes here because people recommend me. I would do the same with other vendors: we all recommend each other”. A producer of garments said, “They know me in Gamarra and they recommend me to the other shop owners. They know that I produce quickly, that the quality is good and that I always make new models”. Of the thirteen micro-entrepreneurs using word-of-mouth advertising, eight work at home, four in a market and one is a taxi driver. Regarding the type of activity, eleven are involved in production and trade and one is involved in trade and transport services, respectively. This suggests that social networks are the main source through which micro-entrepreneurs find clients, especially if they work at home and are involved in production and trade.

Moreover, ten (43,5%) micro-entrepreneurs go directly door-to-door. Among these, seven work at home and nine are involved in production and trade. As in the case of word-of-mouth advertising, going door to door seems to be a common way to find clients for those who work at home and are involved in production and trade. A woman producing bags said, “I go door-to-door in all hotels asking if they need anything”. A woman producing clothing and uniforms said:

“I go by all the most famous schools around here to see if they need someone to produce the uniforms for their students. It is important that I go there with my samples so that they can see how I

work and choose the ones they like. I have to go to them, because they will never come and look for me as they could never find me”.

Summing up, word-of-mouth advertising and going door-to-door are the most common ways through which micro-entrepreneurs find clients. These alternative forms of publicity complement and are much more commonly used than visiting cards, leaflets, posters and participation in fairs and expositions. This confirms the importance of social networks to overcome difficulties in finding clients.

*c) Partial formalization: Registration in the Unified Business Register*

Another strategy micro-entrepreneurs adopt to expand their sales is to partially formalize their business by registering it in the Unified Business Register. This allows them to supply formal clients, who require invoices for their purchases.

In Peru all enterprises are required to register in the Unified Business Register called *Registro Unico de Contribuyentes* (RUC) and to request a license in the Municipality where the activity takes place. Micro-entrepreneurs were asked whether they comply with these two requirements and why they do or do not. Answers are shown in table 13.

**Table 13: Compliance with RUC and municipal license (n=23)**

	Compliance	Number of answers	% of answers
<b>RUC</b>	Yes	18	78,3%
	No	5	21,7%
<b>Municipal License</b>	Yes	6	26,1%
	No	15	65,2%
	Not available	2	8,7%

As shown in the table, eighteen (78,3%) micro-entrepreneurs are registered in the RUC, and only five (21,7%) are not. On the other hand, fifteen (65,2%) micro-entrepreneurs do not have a municipal license, and only six (26,1%) have it. In two cases information about the municipal license is not available.

In order to understand why there is such a difference in the degree of compliance with the registration in the RUC and with the municipal license, micro-entrepreneurs were asked what are the advantages, if any, of the two formal requirements. Table 14 shows the distribution of answers with a breakdown by degree of compliance with the registration in the RUC and with the license.

**Table 14: advantages in complying with the RUC and municipal license (n=23; multiple answers possible)**

Advantages	Frequency	% of answers	No where registered	Only RUC	Only license	Both	Data on license not available
Formal and bigger clients	11	47,8%	0	8	0	2	1
No fear of tax authority controls	3	13%	1	0	0	1	1
Supply public administration	3	13%	1	1	0	0	1
Possibility of advertising	2	8,7%	1	0	0	0	1
There are no advantages	5	21,7%	3	1	0	1	0

As shown in the table, eleven (47,8%) micro-entrepreneurs indicate that the main advantage in formalizing is to be able to supply formal and bigger clients. Among them, eight

are registered in the RUC, two are registered in the RUC and have the license, and one is registered in the RUC but no information about the license is available. Note that none of them has only the license. This is because micro-entrepreneurs register in the RUC in order to supply formal clients. On the other hand, they do not necessarily need a license to do so. The taxation system is structured in such a way that clients can benefit from tax credits if they present a receipt of their purchases, which can be issued only by formal producers or vendors, i.e. only by those who are registered in the RUC. Being able to give a receipt to clients seems an appealing incentive for producers and vendors, as it guarantees them a higher number of clients, even if it means paying income tax on their profits. Particularly interesting are some comments provided by micro-entrepreneurs. A woman producing bags said, "I am registered in the RUC because formal clients ask for a receipt and would go to someone else if I did not give them one". A woman selling bags and cases for different items said, "Of course I am registered in the RUC: it is expensive but big clients ask for it". A micro-entrepreneur producing garments said, "It used to be different but now if you want to have a big business you have to be registered in the RUC". Another micro-entrepreneur said, "Now it is easier to register and it is necessary to supply big clients".

Regarding the other advantages in formalizing, three (13%) micro-entrepreneurs indicate the possibility of supplying public administration, and two (8,7%) mention the possibility of advertising their products. The low number of micro-entrepreneurs indicating these advantages, however, suggests that supplying public administration is not an option for the majority of micro-entrepreneurs, and also that increasing visibility through publicity is not a high priority for micro-entrepreneurs, since they prefer to expand sales in other ways, as we have seen. Regarding supplying public administration, a producer of bags and cases for different items said, "I was lucky to be part of a consortium of micro-producers supplying the public administration. Alone I could never have done it". Another micro-entrepreneur said, "I would really like to be able to supply a high demand but I only have few machines". Additionally, information on public programs is often not widespread among micro-entrepreneurs.

Three (13%) micro-entrepreneurs mention not having to fear inspectors and being able to develop their business as an advantage of complying with the RUC and the license. This small percentage suggests that the law is often not enforced and that the costs for not respecting it are not very high. It is likely that stricter controls matched with more incentives in being formal would increase the degree of compliance, especially of those conducting more remunerative businesses.

Finally, five (21,7%) micro-entrepreneurs indicate that there are no advantages in formalizing. Among them, three are not registered anywhere, one is only registered in the RUC and the other one has both the RUC and the municipal license.<sup>26</sup> A woman producing articles for clothing said, "The government does not give you anything in exchange if you pay. It is exactly the same". Another micro-entrepreneur said, "It is really expensive". A vendor in a market said, "It is not that it gives you advantages being formal, but that is what the law says". This suggests that there may be, at least in some cases, an underestimation of the benefits and an overestimation of the costs of formalization due to a lack of adequate information.

It is interesting to note that none of the micro-entrepreneurs interviewed has only the license. This suggests that only those who have already partially formalized their business get the license and that it is considered less necessary than the RUC. This is confirmed by the interviews, since micro-entrepreneurs declared that the municipal license is a very high cost, particularly because it is a fixed cost and is not related to profits or to the size of the activity. For

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<sup>26</sup> Of this three, two are taxi drivers and their perception of formality not having advantages is in line with the fact that most Peruvians indifferently choose to go on a formal or an informal taxi (although formal taxis can be distinguished from informal ones).

example, a micro-entrepreneur producing articles of clothing said, “I have the RUC but I do not have a license. It is too expensive, especially now that my activity is not going well. At least in the case of the RUC, I pay depending on how much I earn”. Another micro-entrepreneur said, “My business is small but the license costs the same for small and big businesses. I simply cannot afford it”. An artisan said, “What if I pay for the license and my activity goes bad?” Note, moreover, that some micro-entrepreneurs provided the information that the lower degree of compliance with the license occurs because the license does not provide any advantage but also because of the less strict controls of the municipality compared to the National Superintendence of Tax Administration (SUNAT).<sup>27</sup>

Summing up, the main reason why micro-entrepreneurs comply with the registration in the RUC is to be able to increase the number and size of clients and, in this sense, compliance with the inscription in the RUC can be considered a strategy to expand their sales. Additionally, the difference in the degree of compliance with the registration in the RUC and the municipal License is explained by greater advantages of having the RUC. Finally, these results confirm that fiscal incentives can be successful in fostering the formalization of micro-enterprises.

## 6. Credit access

In this section we analyze whether micro-entrepreneurs have ever made use of credit and, if they have, of which kind and at which stage of the development of their business. Additionally, we focus on the reasons why micro-entrepreneurs make or do not make large use of credit, in particular of bank credit.

### a) Do micro-entrepreneurs use credit?

Micro-entrepreneurs were asked whether they have *ever* used credit and, in particular, bank credit to develop their business. Table 15 shows the distribution of answers with a breakdown by gender. Note that because of our greater interest in having more detailed information on bank credit, there is probably an underestimation of the percentage of micro-entrepreneurs receiving credit from family, friends and suppliers or through a *junta*.<sup>28</sup> Moreover, since two of our key informants were managers of cooperatives, there is probably an overestimation of those who use credit from cooperatives.

**Table 15: Have you ever accessed credit in your activity? If yes, which kind of credit?  
(n=23; multiple answers possible)**

<sup>27</sup> The SUNAT is the public institution which administers the RUC. These less strict controls might also suggest the existence of what Tendler (2002) called “the devil’s deal” arguing that sometimes there is “a kind of unspoken deal between politicians and their constituents”, the small informal firms, based on the fact that “if you vote for me, I will not collect taxes from you; I will not make you comply with other tax, environmental or labour regulations and I will keep the police and inspectors from harassing you.” In such a context, as stated by Tendler, informality becomes “more attractive, and formalization less attractive than they otherwise might be”. Clearly, such an agreement is more likely to work at the Municipal level, than at the National level.

<sup>28</sup> A *junta* is an informal saving and credit system. Each member of a small group of people contributes with a given amount to a pot periodically. The pot is given in rotation periodically to one of the members. The order of rotation is generally determined by lot, although in some cases, members in need can be given priority. The contribution can be given daily, weekly or even monthly. The amount of the contribution as well as the number of people involved varies according to the members’ decision. When all members have received a pot the group decides whether to continue, include new members or disband. Since the system is based on trust (those who have already received the pot have to keep contributing for the system to work) among members, they are generally friends or members of the same market or family.

	Number of answers	% of answers	Male	Female	
<b>No</b>	3	13%	3	0	
<b>Yes</b>	20	87%	11	9	
	Friends	2	8,7%	0	2
	Family	4	17,4%	3	1
	Cooperatives	7	30,4%	2	5
	Bank	12	52,2%	9	3
	Junta	2	8,7%	1	1
	Suppliers	2	8,7%	1	1
	NGOs	3	13%	1	2

As shown in table 15, twenty (87%) micro-entrepreneurs have made use of credit at some point in time. Among them, twelve stated that they have used bank credit to finance their activity either recently or in the past. Seven micro-entrepreneurs stated that they have used credit from cooperatives and four credit from family members. Three micro-entrepreneurs stated that they have used credit from NGOs, and two micro-entrepreneurs have made use of credit from friends, suppliers or a *junta*. None referred to obtaining credit from moneylenders.

Note that micro-entrepreneurs can access bank credit only to expand an existing business, while they use their own savings or borrow from their family to start a new activity. This can be inferred from some information collected by the author in banks serving micro-entrepreneurs as well as from the answers provided by micro-entrepreneurs about the resources they used to start the current activity. In fact, in order to obtain a bank loan, banks require that a business has been operating for at least six months (in some cases it is required a minimum of one year).<sup>29</sup> Moreover, table 16 shows the resources micro-entrepreneurs used to start their current activity.

**Table 16: Resources to start the current activity (n=23; multiple responses possible)**

Sources	Number of answers	% of answers
Personal savings	20	86,9%
Help of other members of the family	5	21,7%
Other sources	2	8,7%
Not available	1	-----

As shown in table 16, twenty (86,9%) micro-entrepreneurs started their activity with their own savings. Five others (21,7%) also started with the help of other members of the family, and all of them also used their personal savings. In other two cases (8,7%) micro-entrepreneurs started their current activities through other sources of funding.

<sup>29</sup> According to the information collected in four banks serving micro and small enterprises in Lima (MiBanco, Edypyme, Solucion Financiera, Banco del Trabajo), the other requirements which have to be fulfilled to obtain credit are:

1. To have an Identity Card;
2. To own a house or a laboratory and to be able to prove to be the owner through a property title. In case of not being the owner, to have, as guarantee, the endorsement of a person who owns a house or another real estate.
3. To have registered the business in the Taxpayer Register and regularly pay taxes: the receipts of the payments to the Government office (SUNAT) of the last three months are considered as proofs of the inscription. Some banks also ask for the Municipal License, others ask for it only if the business is not registered to the Sunat. In some cases the receipts of the payments of water and light are necessary as well as the receipts of the purchase of inputs, raw materials and fixed capital.

The difficulty in getting credit to set up a new business was confirmed also by the respondents. A micro-entrepreneur said, “It is not easy to obtain credit. Maybe you can get some money from people you know, but only after they see that your business is developed and you already have a reputation, not in the beginning”.

Additionally note that, according to the interviews, credit obtained from banks serves different purposes than credit obtained from NGOs and cooperatives. There are two main reasons for this. First, because the amount that can be obtained from a cooperative is proportional to the money deposited as savings. Consequently such loans are generally quite limited and it is only enough to finance working capital. The amount that can be borrowed from a bank, in contrast, is larger and often enough to finance both working and fixed capital. A shoemaker said, “I borrow money from the cooperative, but the amount they give me it is not sufficient to buy a machine. Therefore I generally use it to buy some raw materials. If I need to make big investments I ask for a bank loan”. Second, banks often give longer-term loans than do cooperatives. These differences between the two institutions are confirmed by the fact that five micro-entrepreneurs volunteered the information that in the busiest periods (such as Christmas) whenever they need credit to finance the working capital to buy inputs and raw materials, they either ask credit from a bank or a cooperative, depending on the amount of money they want and the time they require to pay back the loan.<sup>30</sup> One micro-entrepreneur said, “Banks generally give longer periods to repay. But cooperatives are much more flexible”.

In terms of gender breakdowns, nine of the twelve micro-entrepreneurs accessing bank credit are men and only three are women (see table 15). In contrast, of the seven micro-entrepreneurs who make use of credit from cooperatives or NGOs, five are females. This gender imbalance should not necessarily be attributed to a bias against women by banks, but to a bias towards women by cooperatives and NGOs. Cooperatives and NGOs often prefer to give credit to women, as they are considered more reliable. For instance a manager of a cooperative said, “Women are more responsible. They generally make a better use of the money and they repay on time”. Additionally, women are more likely to become members of these institutions because of their greater involvement in the community. A woman micro-entrepreneur selling in a market said, “I know a lot of people in this neighbourhood because I am involved in many activities. I am a member of a cooperative and of a group of women producing crafts, and I am also involved in all events organized by the church”. Moreover, women often prefer to rely on sources of credit other than banks. For instance, a woman producing at home said, “Why should I borrow from a bank when I can borrow from NGOs and cooperatives? They are less strict, closer to my house and I feel safer”.

### **b) Is credit considered a convenient option?**

The previous question refers to whether micro-entrepreneurs have *ever* made use of credit so that the percentage of people reporting to have used credit is quite high. This does not mean, however, that micro-entrepreneurs make large use of credit. In order to understand the micro-entrepreneurs’ use of earnings, they were asked whether they earn enough to reinvest or save some money. Table 17 shows the distribution of answers.

**Table 17: Use of earnings (n=23; multiple answers possible)**

<sup>30</sup> Especially in the busiest periods, many members of the cooperatives ask for credit. Since sometimes cooperatives do not have enough deposits to give credit to all members who ask for it, those who ask for credit receive a lower amount than they originally wanted or the name of who gets the loan is drawn.

Use of earnings	Number of answers	% of answers
Bank savings	1	4,3%
Savings	8	34,8%
Reinvestment in the activity	20	86,9%

First note that all micro-entrepreneurs interviewed declared that they earn enough to be able to save some money. This suggests that, although competition is high, micro-entrepreneurs manage to make some profits. As shown in table 17, nine (39,1%) respondents save their earnings but only one puts his savings in a bank. This indicates that, although micro-entrepreneurs sometimes access bank credit, bank accounts are still not in widespread use among them. The great majority (twenty) of micro-entrepreneurs reinvest their earnings in their activity, mainly to finance investments in fixed capital. This suggests that micro-entrepreneurs do not make large use of credit. Also, such a high percentage of respondents reinvesting in their own activities is due to their fear of losing the purchasing power of their savings and their preference to reinvest them for expanding their activity. Most micro-entrepreneurs, in fact, have lived through the macroeconomic crisis of the second half of the 1980s – which they refer to as “the Garcia Presidency” – during which hyper-inflation virtually nullified the purchasing power of their savings.

Some other information volunteered by micro-entrepreneurs also confirms that micro-entrepreneurs do not make a large use of credit. Twelve micro-entrepreneurs mainly produce to order and seven of these volunteered the information that they ask clients to pay in advance in order not to invest in unsold products. This suggests that micro-entrepreneurs use production to order and advance payment to reduce their problems of financial shortage and to avoid the risk of getting into debt. A micro-entrepreneur working at home producing pieces of furniture said, “Before buying raw materials I get orders from clients and I ask them to advance me some money. For the work they will pay later, but for raw materials it is better if clients give me money in advance so I do not have problems in getting the money from other sources to buy raw materials”. Another micro-entrepreneur said, “I only produce when I get an order from a client. I cannot put money in something that I am not sure to sell”.

Moreover, six micro-entrepreneurs stated that they generally do not need credit because they make enough profit, and five volunteered the information that they earn money quite quickly after having invested it and therefore do not face particular problems with financial shortfalls. In other words, there are a number of micro-entrepreneurs whose earnings are sufficient to finance both the working and the fixed capital they need, whereas others mainly rely on advanced payment.

Micro-entrepreneurs also volunteered some comments about banks and their reasons for not making more use of bank credit. Six micro-entrepreneurs stated that they prefer not to access bank credit because interest rates are very high. Note that micro-entrepreneurs often do not know how high the interests are but are convinced that bank conditions are not convenient. One micro-entrepreneur said that even if he could access bank credit he would rather ask for credit from moneylenders because it is more convenient. Four other micro-entrepreneurs complained about penalties for late payment being very high and said that they prefer not to access bank credit because they fear not being able to pay back on time and of being expropriated. For instance, a vendor in Caquetà market said, “If I am late, I will have to pay too much. I know it because I have a friend who had such a hard time repaying because she was late and her debt was growing very fast”. Another artisan said, “If I am late than the bank will take my house, and it is the only thing I own”. Five micro-entrepreneurs also volunteered the information that they do not like to have debts (three are women) especially if it is with banks. A woman producing at home said, “I prefer not to have debts: I prefer to do what I can do with the money I have”. Four micro-entrepreneurs also underlined that they do not trust banks because some went bankrupt during and right after the 1980s crisis and people lost all their money. A

lady selling bags in a market said, “What if I lose all my money? It happened to more than one person I know that they lost all the money when CLAE went bankrupt”.<sup>31</sup> Moreover, three micro-entrepreneurs also volunteered the information that they fear the consequences of giving detailed information about their business and other three that going to banks is expensive both in terms of time and money needed to reach them, as they are often quite far from where micro-entrepreneurs work.

Summing up, the great majority of micro-entrepreneurs have made use of credit at some point in time. Those who have accessed bank credit have done it at a later stage of development of their activities and not at the beginning. However, micro-entrepreneurs do not make a large use of credit, neither at the beginning of their activities nor at a later stage. The most common way to avoid asking for bank credit is to finance their fixed and working capital with their earnings or to ask clients to pay in advance.

## **7. Conclusion**

This paper presents the results of field research on informal micro-entrepreneurs conducted in Lima, Peru, between December 2001 and February 2002. The research addresses the problems faced by these micro-entrepreneurs and the strategies used to overcome these problems, as well as the varying extent to which these micro-entrepreneurs are informal.

We found that for most micro-entrepreneurs interviewed, expanding their businesses and finding new clients can be a problem. We then investigated what strategies micro-entrepreneurs adopt to overcome these difficulties in finding clients. The majority of micro-entrepreneurs stated that clients buy from them because they know the micro-entrepreneur on a personal basis and because they produce to order. In contrast, prices are not considered by micro-entrepreneurs as a major factor influencing clients' decisions, while other factors – such as quality and location – seem to be more relevant.

According to the interviews, micro-entrepreneurs do not appear able to lower the price of their products. Additionally, micro-entrepreneurs have only limited possibilities for advertising their products through posters and shop signs and consequently use word-of-mouth advertising and door-to-door selling. Another strategy micro-entrepreneurs use to expand their sales is to partially register their business in order to be able to supply formal clients. Since the reforms of the 1990s, by registering in the Unified Business Register micro-entrepreneurs are able to issue an invoice, which formal clients require in order to benefit from tax credits. The success of the Unified Business Register suggests that policy makers have to create incentives for micro-entrepreneurs by expanding opportunities to make formality more appealing and convenient. The reduction of costs and the simplification of requirements do not seem sufficient by themselves to foster formalization.

The importance of providing micro-entrepreneurs with incentives is also stressed by the low compliance with the municipal license. According to the interviews, most micro-entrepreneurs do not apply for a license. The low degree of compliance with the municipal license has two main explanations. First, the license is often considered a very high cost, as it is a fixed cost and is not related to the profitability of the activity. Second, the license does not provide micro-entrepreneurs with expanded market opportunities.

From the interviews it is clear that the law regarding the municipal license has to be changed in order for these micro-entrepreneurs to fully formalize. A first option could be to eliminate the obligation of complying with the municipal license. This, however, would not

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<sup>31</sup> Centro Latinoamericano de Asesoría Empresarial (CLAE) is an informal finance entity collapsed in 1992 and closed by the State in 1993, where about 212000 people put their savings.

probably be feasible for Municipalities, as licenses are one of the means through which the local authorities collect revenues. A second more applicable option is to modify the law by creating incentives for micro-entrepreneurs and thereby making formality more desirable. This could be done by providing some advantages in terms of market opportunities and by making the cost of the license proportional to the income or profits of the micro-entrepreneurs, as is the case with the RUC.

We also believe that getting micro-entrepreneurs to formalize should not be considered a policy objective in itself. A higher degree of formalization is desirable only if it leads to greater welfare for micro-entrepreneurs. For this reason, policy makers should pursue formalization by creating incentives for formal micro-entrepreneurs. A higher degree of formalization, in fact, is the consequence of greater advantages of being formal.

Moreover, although providing micro-entrepreneurs with incentives is necessary to achieve a higher degree of formalization, it may not be sufficient. In order to succeed in increasing formalization, policy makers should take into account the importance of adequate information. Targeted information to micro-entrepreneurs about the benefits derived from complying with the law could be useful to achieve this goal. Additionally, business associations could accelerate the process of formalization by representing the interests of micro-entrepreneurs and by improving knowledge of services (such as regarding fiscal counseling, accounting, payroll, etc.), which could help small businesses comply with formal regulations.

Finally, although micro and small enterprises are often considered a potential for employment generation and development, there are still many obstacles that micro-entrepreneurs have to overcome before the informal sector and micro-enterprises can play this dynamic role. These obstacles have to be removed from the top, by targeted and adequate macroeconomic and microeconomic policies and a friendlier legal framework, and from the bottom, by the micro-entrepreneurs and workers themselves. Only then will micro and small enterprises have a real potential for employment generation and growth.

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## **Appendix**

Open-ended questions made during the interviews to the micro-entrepreneur.

### **1) Background on the enterprise**

- a. Type of activity
- b. Location and dimension of the enterprise
- c. When did you enter the current activity? Why? With what resources did you start the current activity?
- d. How many machines do you have? With what resources did you buy them?
- e. How many employees do you have? Is anyone of them a member of your family? Who is in charge of what?
- f. How do you choose your workers? Did you know them before they started working in your business? How did you find them?
- g. Where do you buy the raw materials? Do you always buy from the same suppliers?
- h. What do you do with the money you earn?

### **2) Market related issues**

- a. Which kind of clients do you supply? Do you supply only single consumers or also micro or small enterprises? Do wholesalers buy from you?
- b. Why do you think clients buy from you and not from another vendors?
- c. Do you have problems in finding clients? If yes, why?
- d. Are your earning stables?
- e. How do you set the price of your products? Do you consider the price set by other competitors?
- f. Do you advertise your activity? How?
- g. How do you find your clients? In the case they were home they were asked why they did not work in a market.
- h. Do you know your clients? Are they friends of yours?

### **3) Formalization**

- a. Are you registered in the Unified Business Register? Why or why not?
- b. Do you have a municipal license? Why or why not?
- c. Are your workers registered? Do you give them all the benefits?
- d. What is the most important advantage in complying with the RUC and the municipal license?

### **4) Credit**

- a. Have you ever used credit? What kind of credit? Why did you use this/these kind/s of credit and not others?
- b. Have you ever used bank credit? If yes, from which bank? Which was the monthly rate you were paying and for how long did you pay?
- c. Was the bank fast in giving you the money? Did you go to the bank or they came to you? Why did you decide of borrowing money from that particular bank and not from another one?
- d. Which requirements were you asked for when you asked credit to a bank? Did you have problems in complying with them?
- e. Do you often ask for credit? Why or why not?