



Informality Revisited

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Summary. — The paper draws on recent evidence—economic, sociological and anthropological—from Latin America to forward a view of the informal sector in developing countries primarily as an unregulated microentrepreneurial sector and not as a disadvantaged residual of segmented labor markets. It offers alternative explanations for many of the characteristics of the sector customarily regarded as evidence of its inferiority.

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1. INTRODUCTION

Three decades of research have not yielded consensus either on the definition of the informal sector or its “*razon de ser*.”¹ Broadly speaking, the small-scale, semi-legal, often low-productivity, frequently family-based, perhaps pre-capitalistic enterprise continues to employ between 30% and 70% of the urban work force in Latin America. A long tradition views informal workers as comprising the less-advantaged sector of a dualistic or segmented labor market.² Above market-clearing wages force workers to queue for preferred jobs while subsisting in an inferior sector characterized by an absence of benefits, irregular work conditions, high turnover and, overall, lower rates of remuneration.

This paper revisits this conception of the informal sector in light of recent evidence and concludes that it does not convincingly describe the Latin American case. I argue that as a first approximation we should think of the informal sector as the unregulated, developing country analogue of the voluntary entrepreneurial small firm sector found in advanced countries, rather than a residual comprised of disadvantaged, workers rationed out of good jobs. I do not pretend to provide an exhaustive account of the informality literature but rely heavily on my own accumulated work on Argentina, Brazil and Mexico. All three countries have rare panel data that permit following workers as they move among sectors, and Mexico has a detailed microenterprise survey that permits careful study of the characteristics and choices of the

informal microentrepreneur. Mexico also gets special attention because, despite compelling descriptions of the inflexibility, inefficiency and costliness of the Mexican labor code,³ the usual sources of wage rigidity that would segment the market seem absent: minimum wages have not been binding for the last decade, unions to date have primarily been concerned about preserving employment rather than raising remuneration, and wages have shown extraordinary downward flexibility during crises.⁴ As such it provides an interesting paradox of a relatively flexible labor market accompanied by a very large informal sector.

This view of the voluntary informal entrepreneur has important implications for how we think about good vs. bad jobs, “unprotectedness” and precariousness. The International Labor Organization, for instance, defines “decent” work as jobs covered and protected by formal labor institutions.⁵ Yet, if in fact much of the sector is voluntary, in the sense of

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workers preferring their present job to one in the formal sector, then the informal job must be at least of equal quality measured along broader set of relevant job characteristics. Workers would appear to find substitutes for the protection or services offered by formal institutions, or are willing to trade formal protections off for another dimension of job quality. Either implies that we need to think less dichotomously about the state of protection and more in terms of a broader continuum of jobs that offer different packages of qualities. Less-developed country (LDC) labor markets probably function better than the traditional view would suggest, and we probably need to revisit the issue of the optimal design of social protections.

Arguing that workers are voluntarily informal does not, of course, imply that they are not living in poverty, only that they would not obviously be better off in the formal jobs for which they are qualified. Being in the informal sector is often the optimal decision given their preferences, the constraints they face in terms of their level of human capital, and the level of formal sector labor productivity in the country.

Finally, it is also critical to acknowledge that the informal sector is very heterogeneous and the view I am laying out here will not describe well the peculiarities of every subsector. The bulk of the analysis focuses on the largest group of the informal, those males who are self-employed or owners of unregistered microenterprises with less than five employees which I group under the term "informal self-employed." I will also argue that once we understand the particular constraints and opportunities facing both the "informal salaried," those working in microenterprises without protections, and women in various modalities of informal work, their presence in the informal sector may also reflect a greater measure of choice than is generally attributed.

2. THE CORE OF THE INFORMAL SECTOR—THE SELF-EMPLOYED

Informal self-employment in Latin America generally constitutes the largest source of employment among men after formal salaried employment, in some cases exceeding 40% of the work force. Fields (1990), recognizing the existence of prosperous, voluntary group within the sector, also identified earlier by Hart (1972) in Kenya, argued that this constituted a

second tier of the sector that made it more heterogeneous than the original Todaro dualistic formulation might lead us to believe. How big is this voluntary component? I'll take several approaches to measuring it but we can begin simply looking at motivational responses from survey data. In every case, we are looking at owners of firms from 0 to 5 employees who are uncovered by any social benefits and have no more than a high school education.

Focusing for now on men, Table 1 shows that, for Mexico, well over 60% of those in the informal self-employed sector left their previous job and entered the sector voluntarily—a desire for greater independence or higher pay as the principal motives.⁶ These findings are consistent with the sociologists Balán, Browning, and Jelin (1973) extensive interviews with Monterrey workers who state that being one's own boss was well-regarded and that movements into self-employment from salaried positions often represented an improvement in job status.⁷ They also find resonance in response data from elsewhere in the region. In the mammoth Brazilian Annual National Domestic Survey, over 62% of self-employed men stated that they did not want a formal sector job, primarily because they were happy with their current job.⁸ A smaller survey from the province of Jujuy, Argentina revealed that 80% of the self-employed had no desire to change jobs and under 18% saw self-employment as a temporary activity before they found a "real" job.⁹ In Greater Buenos Aires, another survey found that while 36% would have preferred to work more hours, only 26% were looking for other work.¹⁰ In Paraguay, only 28% of those in the informal sector (both self-employed and salaried) stated a desire to change occupations.¹¹ All broadly echo Blanchflower and Oswald's (1998) finding that 63% of workers from the United States, 48% of Britons, and 49% of Germans would prefer to be self-employed suggesting that LDC microentrepreneurs may be similar to their advanced country counterparts in their reasons for being self-employed.

In fact, estimations of Markov transition matrices using panel data on worker transitions from Argentina, Brazil, and Mexico, all suggest patterns of entry similar to those found in the US literature.¹² They reject emphatically self-employment as an entry occupation from school and there is little evidence that the sector serves as a holding pattern for young workers looking for jobs. As one example, broadly

replicated in the other surveys, the National Urban Employment Survey (ENEU) from Mexico shows that transitions into self-employment from the other paid sectors occur 4–6 years later than transitions into formal or informal salaried work leaving the mean age eight years higher than the next closest sector.¹³ This late entry into self-employment mimics Evans and Jovanovic's (1989) finding from the United States that, while it might be expected that younger workers would be more prone to take on the risks of self-employment, it is older workers who are more likely to enter. They attribute this to credit constraints that dictate that potential entrepreneurs must acquire the necessary physical and working capital by accumulating savings, a finding supported by Blanchflower and Oswald's (1998) interviews with entrepreneurs in several advanced countries. Such constraints in turn may be exacerbated in developing countries where not only do credit markets function poorly, but weak educational systems make the accumulation of human capital difficult as well. Balán *et al.* (1973), argue precisely for a "life cycle" model in Mexico where workers enter into salaried work, accumulate knowledge, capital, and contacts, and then quit to open their own informal businesses.¹⁴

Late entry is, of course, also consistent with fired older workers being unable to find a new formal sector job. The Guadalajara sociologist Gonzalez de la Rocha (1994) is almost certainly correct that for many older workers, the sector does provide a safety net by offering "insecure occupations (such as the services) in which their age is not a limitation after they have been kicked out of the formal manufacturing or formal services." This dynamic may have been of particular relevance during the economic restructurings of the 1990s where older displaced workers may have found their skills obsolescent and little demanded in the emerging sectors. She does also, however, suggest some degree of voluntary movement when she says that "Older men may also find the pace of industrial (formal) work too arduous and leave such jobs." This more voluntary take is stressed by anthropologists Selby, Murphy, and Lorenzen (1990) who note the "surprising desirability of informal sector employment as the basis for a household earning strategy, particularly for poorer, older households with lower educational qualifications" (p. 144).

The coexistence of both motives is fully consistent with the sector being roughly 60–

70% voluntary and the remainder involuntary emerging from the interview responses. Analysis of the distribution of earnings within the sector also broadly supports these proportions. Cunningham and Maloney (2001) argue that if, in fact, there are two types of firms with distinctive modes of operation and dynamics, we might expect the observed distribution of earnings adjusted for human capital and other relevant factors to be comprised of two underlying distributions corresponding to the inferior and superior subsectors.¹⁵ That is, entrepreneurs who chose to go into the sector might be expected to be better prepared or intrinsically more able to run a business, than those who are thrown involuntarily in the sector. In fact, I had previously found that workers voluntarily transiting into self-employment from formal salaried work earned substantially more than those who entered involuntarily. We were able to identify statistically two distributions thereby supporting an upper–lower tier view, but the share of the population found in the "lower" tier was only 13% of the sample. This is in the ballpark of the 30% reporting involuntary entry into the sector.

Macroeconomic time-series data also offer support for a large voluntary component of the sector, although the magnitude can vary across the business cycle. The traditional "dualistic" view would argue that as the economy enters a recession, we should find workers being forced into the informal sector, driving down wages there relative to the formal sector wage. This does seem to be the case in Colombia after 1995, a period of deep recession due to a financial crisis combined with a ill-advised but dramatic rise in the minimum wage that accentuated the segmentation in the economy. Figure 1 shows that the relative size of the formal sector relative to the informal self-employed sector fell while its relative wage rose—exactly the pattern predicted by the dualistic view. But Figure 2 suggests that the 1987–92 recovery period was very different in Mexico. Here the share of the workforce in self-employment grew at the same time that the informal self-employed went from earning roughly the same amount as formal salaried workers, to 30% more by 1992. Fiess, Fugazza, and Maloney (2002) document substantial periods of comovement of relative earnings and sector size earnings in both Mexico and Brazil at conventional levels of statistical significance so the eyes do not deceive. It also makes sense. The boom in construction and other

Table 1. *Mexico: interviews with informal self-employed workers*

	Men	Women
<i>Reasons for leaving last job</i>		
Fired, firm closed, contract ended	20.4	11.46
Low pay	21.68	10.93
To be independent	36.89	10.23
Retired	2.31	0.53
Moved	4.1	5.11
Married	0.35	46.03
Illness	4.29	7.05
Other	9.98	7.05
Observations	5,923	567

Source: Author's calculations.

Table 2. *Brazil: interviews with informal sector workers*

	Self-employed		Informal employee	
	Men	Women	Men	Women
(1) <i>Would not like to be a formal sector employee</i>	62.00	51.20	28.80	28.90
(2) <i>Reason for not wanting to be formal</i>				
Earn more in current job	17.20	9.10	10.20	3.90
Competing household chores	0.20	31.40	0.05	12.60
Need time for other activities	3.00	7.30	4.90	6.40
Happy with current job	65.20	41.10	68.20	65.20
Did not want to undertake requirements to be formal	11.00	7.40	10.00	7.80
Other	3.40	3.40	6.70	4.30

Source: Author's calculations.

nontradable offered many good jobs to informal skilled workmen, and this is when they choose to open their businesses.¹⁶ This pattern reverses somewhat going into the crisis of 1995 where there is an increase in the size of the self-employed sector at the same time that relative self-employed earnings are falling. But, the point here is not to show that the informal sector *never* serves as a safety net. Rather, that in normal times, the majority of entrepreneurs want to be in the sector, and hence that it should not be treated as inherently inferior.

Table 3 offers yet another provocative finding that calls into doubt the notion that the sector should be conflated with disguised unemployment. Here we use panel data from Mexico and Argentina to ask the unemployed with previous job experience what sector they entered from. Surprisingly, 75% of the unemployed in Mexico and 64% in Argentina were informal previously. So the sector is not simply or even primarily absorbing the unemployed from the formal sector who cannot afford to be unemployed—it contributes greatly as well. As we

will see later, there is a logical reason why this may be the case.

Finally, the explanation for the disproportionate representation of women in informal self-employment may also again be found in certain desirable characteristics of the sector, particularly, flexibility.¹⁷ Interview data from Geldstein (2000) for Argentina and Chant (1991) from Mexico suggest that women may more easily balance their productive (market) and reproductive (homecare) roles if they work for themselves than if they are employees. This idea finds support from the motivational responses from Mexico in Table 1 which suggests that almost half of women in informal self-employment left their previous jobs because they got married. A similar story appears in the Brazilian responses in Table 2 where of the over 50% of those women reporting that they are not looking for a formal sector job, 31% said the reason was competing household chores. Logit regressions from Argentina, Mexico, Costa Rica and Brazil suggest that women with young children are

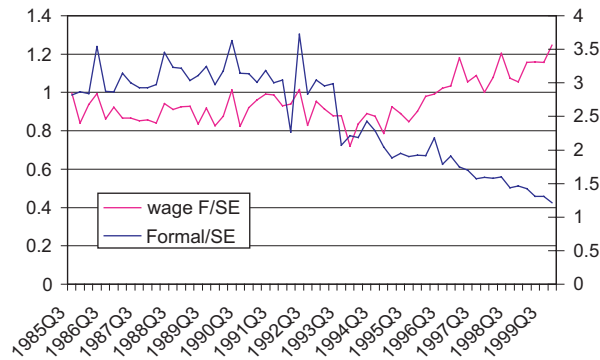


Figure 1. Colombia: relative sector size and earnings.

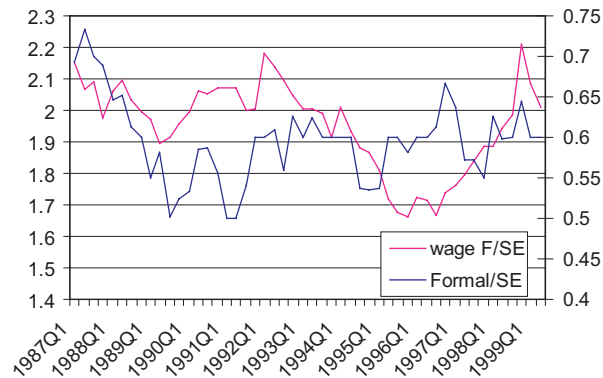


Figure 2. Mexico: relative sector size and earnings.

more likely to become self-employed than formal sector employees¹⁸ Cunningham (2001a) argues that, while it is true that single Mexican mothers have high levels of participation in informal self-employment, the fact that single women without children have the highest rate of participation in *formal* jobs of any group, male or female, makes discrimination of some form based on gender *per se* less plausible.¹⁹ This is also suggested by the transition matrices from Argentina, Brazil, and Mexico that reveal a vast amount of mobility between being out of the labor force and informal self-employment for women compared to men.²⁰ But, if we only include single women in the matrices, this particular channel of mobility is greatly diminished and the male and female matrices are essentially equivalent. Given the constraints that poor women face in balancing home responsibilities and the need to work, informal self-

employment may be a relatively desirable alternative.

On balance, the sociological and anthropological studies are consistent with the findings of the various microenterprise and employment surveys and the micro- and macroeconomic evidence that most informal self-employed choose to be so, as well as the view that workers may enter formal sector employment initially partly as a means to accumulate human and physical capital. This leads to an intriguing inversion of the traditional dualist view. If firms must pay "efficiency" or above market clearing wages to dissuade their workers from leaving with their training and opening their own firms, this would create a segmented market. But in this case, it may be the attractiveness of informal self-employment that causes dualism rather than a segmented market causing informality.²¹

3. BUT DON'T INFORMAL SELF-EMPLOYED EARN LESS?

The evidence from numerous surveys is mixed. Transition data suggest that Mexican workers who voluntarily enter self-employment *gained* by leaving salaried formal employment and cross-sectional data also suggest they earn more. But such wage comparisons are fundamentally suspect and we should probably not use them as measures of segmentation and job quality. The reason is that if workers were to choose between sectors, they would take into account not only monetary earnings, but all other characteristics and benefits associated with each possible job.

Several examples may make this clearer. First, if the formal sector pays benefits—pensions, health insurance, housing subsidies, day-care—which the informal sector does not, then in a market with no distortions, earnings in the unprotected sector would need to be above the formal sector to compensate for the lost benefits. These higher earnings, of course, would not imply a superior job—only that more of the total remuneration was paid in cash instead of benefits. On the other hand, income taxes support public goods from which tax-avoiding informal workers cannot be excluded (national defense, or minimum pensions, for example), and therefore dictate that formal sector workers need to be paid more to compensate for the taxes they cannot avoid. Further, formal workplaces may be cleaner and safer, but, as in the industrialized world and as Table 1 suggests, being one's own boss and having flexibility is very valuable too and is worth taking a wage cut for. Finally, starting a business is risky anywhere and we should expect to find higher incomes to compensate for this risk.

Though informal salaried workers are generally found to earn less, this may be due to the fact that they are often related to the owners of the enterprises where they work and thus may receive unobserved payments in kind (food, lodging).²² Further, to the degree that the sector appears to play a job training role for young workers, some fraction of the salary may be deducted to cover implicit training costs.

To summarize, in a market with no distortions and hence no segmentation, workers would equate utility, or the total "package" of benefits, not just earnings. To establish segmentation, we would need to add up all of the factors discussed above, many of them unmeasurable, and show that formal sector

workers were better off—an impossible task. This implies that comparisons of wages cannot be tests for segmentation. It also implies that the fact that informal salaried workers may earn less than formal salaried workers does not mean that they are necessarily worse-off when measured in terms of total welfare.

4. BUT AREN'T THESE THE POOREST WORKERS IN THE ECONOMY?

Informal workers, both self-employed and salaried, tend to be drawn disproportionately from the poor. What is more difficult to claim is that their poverty is a result of their job, and not the other way around. The argument that informal employment can be desirable is most compelling where micro-firms can offer remuneration comparable to that earned in the formal sector and this is mostly likely to be the case among low-skill workers unlikely to generate much firm specific human capital. Observing Mexican informal workers, the anthropologists Selby *et al.* (1990) confirm that "On average, the opportunity costs to these workers in terms of foregone earnings in, say, registered blue-collar employment may be quite low" (p. 147). This view is supported by Figure 3 which plot the ratio of the number of self-employed over to the self-employed plus formal salaried (SE/FS + SE) vs. years of education for Argentina, Brazil and Mexico. We find the same downward slope in all countries that is consistent with workers being less willing to enter self-employment as their opportunity cost in terms of formal sector opportunities rises. It is also statistically supported by logit analysis of Argentine and Mexican worker movements between sectors that finds that they become less likely to leave formal employment for self-employment, or any other informal sector, as education levels increase.

Thus to say that workers are voluntarily informally employed does not imply that they are either happy or well-off. It only implies that they would not necessarily be better-off in the other sector. Many are simply making the best choices they can given their low level of education.

5. WHY WOULD WORKERS VOLUNTARILY GIVE UP FORMAL SECTOR BENEFITS?

This issue is central to our whole conception of informality since an important part of the

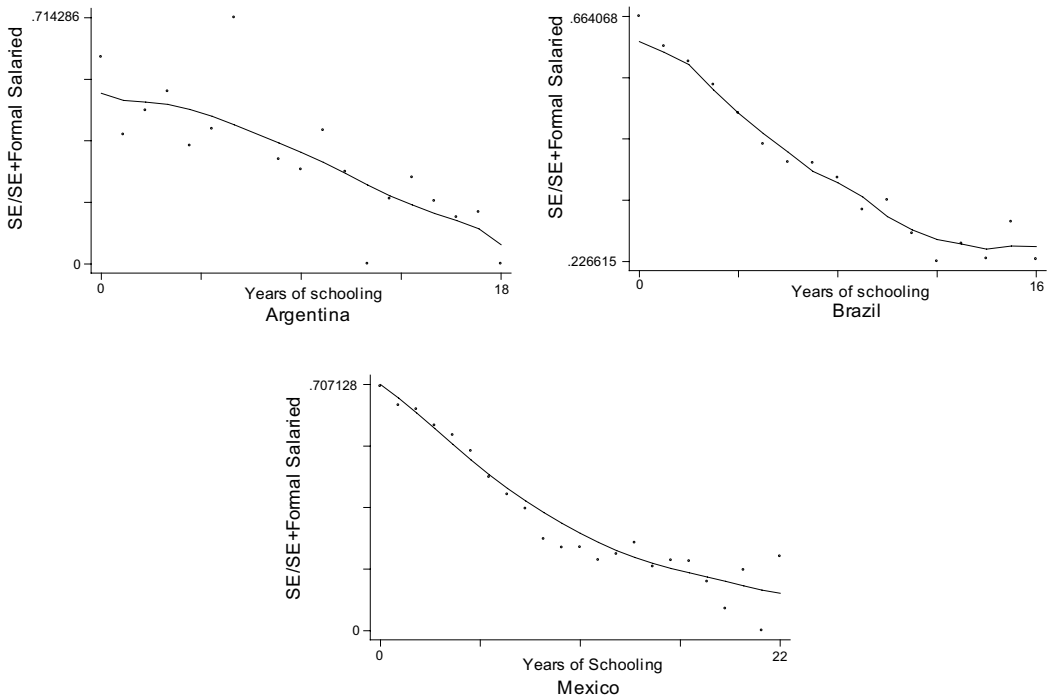


Figure 3. *Size of self-employed sector and years of schooling for Argentina, Brazil and Mexico.*

literature defines good or “decent” jobs as those offering legal recognition and coverage by government protections. This dichotomy is probably excessively Manichean and may not be helpful to understanding either worker welfare or the overall functioning of LDC labor markets: There are numerous reasons why workers may be willing to voluntarily become “unprotected.” These, in turn, imply that we need to revisit the question of the optimal mechanisms for protecting families against the inevitable income and other types of shocks that are part of life.

First, we have to remember that social protections are not free and that, in the absence of nominal wage rigidities, workers pay for them either explicitly or in terms of lower wages. If an alternative exists at lower cost, or which better suits the needs of the worker, there is an incentive to not participate in the formal institution. One trivial example, although relevant in the Mexican case, is that often an entire family is covered by medical benefits when any one member is formally employed, so the return to paying labor taxes, explicitly or implicitly, to the second formal sector worker

is zero—better to receive your remuneration completely in pesos. More generally, informal support networks may be able to substitute for unemployment insurance or retirement funds at lower cost, if only because of lower costs of transaction and of monitoring cheaters.²³ Morduch (1999) concludes after a close review of this literature that “informal insurance exists, but it is not nearly perfect” (p. 7). Nonetheless, numerous of the studies he cites show quite substantial ability to offset income or other shocks. Further it is not clear whether formal sector mechanisms are necessarily more perfect even in practice. Bentolila and Ichino (2000), argue that in Italy and Spain household consumption fell only 20% as much in response to unemployment of the household head as it did in Germany where formal credit and social protections systems were more advanced. They attribute this precisely to the greater influence of (informal) inter household transfers.²⁴ Whichever is superior, poor workers used to living with imperfection may still find settling for “adequate” informal mechanisms justified by the other benefits of entrepreneurship.

The tradeoff may be even less sharp when we consider that the quality of many formal services in LDCs is often poor and administrative overhead costs are very high, causing some workers to see mandatory contributions to benefits programs as a disadvantage of formal salaried work (see Robles, 1989). It is entirely plausible to imagine a microentrepreneur, perhaps faced with borrowing constraints to expand a business, being reluctant to hand over current resources to a government of dubious trustworthiness for a promise of an old-age payment in the distant future. At worst, it means throwing money away if governments raid pension funds to finance fiscal deficits and subsequently cannot honor commitments, at best, it may have a very high liquidity cost, especially if other informal arrangements are available. The latter is suggested by the work on Chile by Barr and Packard (2000) and Packard (2002), who find that participation in the government's voluntary pension scheme, a private individual account scheme with no redistributive dimension, is extraordinarily low, at around 4%. This suggests that these entrepreneurs are choosing to be "unprotected" even by the scheme that arguably best aligns costs and benefits in the region.

Finally, occasionally protections are actually noxious to talented workers. Balán *et al.* (1973)

interviews suggest that the paucity of openings for promotion on the rigid *escalafon* (seniority-driven job ladder) can make informal self-employment the remaining outlet for further advancement.

Because enforcement of legislation in developing countries is not as uniform as in the advanced countries, workers are able to choose to an important degree which benefits programs or formal institutions they participate in, and the optimal degree is not obviously the full formal sector package. This kind of logic is not at all controversial in fields bordering this one. It emerges strongly in strains of the emerging social capital literature that assume that individuals optimize their investment in informal networks with a view toward long-run returns broadly conceived.²⁵ We also know that within the formal sector, individuals choose among degrees of formal sector protection (how much insurance and of what kind to buy). It seems very probable, and the limited evidence suggests, that workers and micro-firms do choose along a continuum of modes of protection and more generally their level and type of engagement with the institutions of civil society.

As one provocative example, Figure 4 presents the wage distributions (kernel density plots) for several countries for both informal

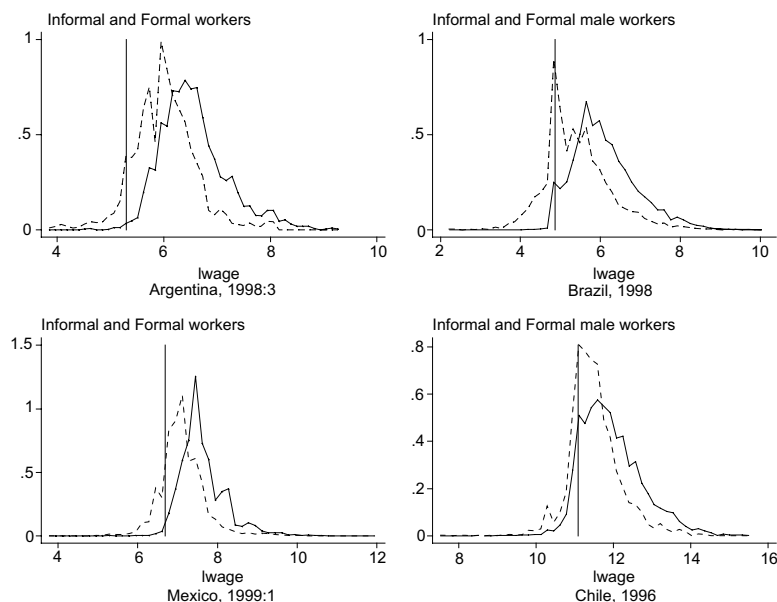


Figure 4. Kernel density estimates of wage distribution. Source: Maloney and Nunez (forthcoming). Estimated density plots of informal salaried (left) and formal salaried (right) distributions. Vertical line is minimum wage.

salaried workers (to the left) and formal salaried workers, to the right and shows that minimum wages are, in fact, most binding, among salaried workers in *informal* firms. This “lighthouse” effect, as it is called in Brazil, suggests that there are norms on level of pay that informal employers follow even if, perhaps for the reasons above they do not register their workers with social security administrations. We will also see below that micro-firms appear to choose the degree of participation in societal institutions more generally according to their business needs.

None of these arguments is particular to LDCs. US teenagers will take temporary jobs without health benefits and remained covered on their father’s plan. The paragon of risk-taking entrepreneurship in the United States, the Silicon Valley start-up pioneer, will leave salaried work and take on full responsibility for medical insurance. In fact, it is not at all unusual to find US citizens who, given the choice, would forego the protection offered by the potentially insolvent Social Security Administration and invest their money differently. We may imagine that those formally covered by the pension and severance programs of Enron or many other troubled US companies might have preferred, with the benefit of hindsight, to have taken home a higher wage and made their own arrangements.

What I am suggesting is that those contemplating opening their own firms may survey the array of available social protection mechanisms, both formal and informal and then, comparing the utility of the portfolio they can cobble together in the two sectors, make the decision to open an informal business and leave formal protections. This view is consistent less with the informal sector being denied protections, as with it offering alternative combinations of characteristics that may be desirable even at the possible expense of some additional uncovered risk. Again, the key difference between the self-employed in the advanced world and those in LDCs may be that deficient enforcement permits the latter to make these choices.

6. ISN’T INFORMAL SELF-EMPLOYMENT PRECARIOUS?

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

the fact that the informal *cuenta-propista* or owner is fundamentally a microentrepreneur—the owner of a small firm. The industrialized country literature on firm behavior offers two important findings about such firms. First, there is a wide range of sizes among long-standing firms determined by such factors as how efficient or hardworking an entrepreneur is, how well-placed his/her firm is, the logic of the production process etc. This means that the existence of many small firms does not necessarily imply failure of either labor or credit markets. It may be that the reason that 80% of micro-firms have only one or two employees and tend to be family based reflects a logic that has roots in the tradition of the family farm, or reflects the sustainable reach of informal contracting relations. This could explain, for instance, the finding that only 10% of urban Mexican micro-firms report plans for expansion and only 9% report that lack of credit is a major business problem.²⁶

A second finding about small firms everywhere is their extraordinarily high rates of failure. Seeking to explain the US case, Jovanovic (1982) argues that this is due to the fact that entrepreneurs cannot know how good their location is, or how good an entrepreneur they are until they actually start the business. Very soon after starting, many find that they are not viable and fail. The sociology literature provides striking confirmation of this insight when Balán *et al.* (1973) argue that although self-employment is a goal for many Mexican workers:

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

In fact, comparisons of patterns of entry and exit derived from the Mexican microenterprise survey appear to be broadly similar to those derived for the United States by Evans and Leighton (1989).²⁷ These high rates of failure may explain the high rates of entry into unemployment found in Table 3. If small firms have high mortality rates, both owners and the workers are more likely to find themselves without employment and searching for a new job.

Table 3. *Sector of origin of the unemployed*

Sector of origin	Argentina 1		Mexico	
	All	Paid	All	Paid
Informal self-employed	18	38	9	40
Salaried informal	12	26	7	35
Formal salaried	17	36	5	25
Previously unemployed	34		19	
Previously out of labor force	6		44	
School graduates	13		16	
Total	100%	100%	100%	100%

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

If we add to this picture a new view of “formality” emerging from the previous section, we can generate most of the characteristics of the sector, but without implying any inferiority or undesired precariousness. Levenson and Maloney (1996) treat “formality” more generally as participation in the numerous institutions of civil society: federal and local treasuries, governmental programs such as social security (including pensions and health care), the legal system, the banking system, health inspection, firm censuses, trade organizations, civic organizations, etc. These, of course, have costs in terms of compliance with legal norms which very small firms can choose to avoid in many developing countries. Small firms are anchored in social networks of family and immediate neighborhood that allow them to enforce implicit contracts, insure against risks etc. while participation in the formal institutions of civil society is needlessly expensive. As firms grow however they increasingly need to secure property rights or permit formal contracting mechanisms, pool risk, gain access to credit—all things that become more important as firms grow. De Soto (1989) offers a striking example where informal street vendors in Peru tried not to avoid, but to pay their taxes since this would guarantee them some property rights over their pitch and hence offer some security to investments they wanted to make.²⁸ Statistically, the data from the Mexican microenterprise survey suggest that firms do become more formal with age and size. Further, those that choose to participate in business associations, credit institutions, training institutions or even the government services that become accessible once they pay their taxes do, in fact, have more prosperous enterprises.²⁹

Combining the two characteristics of micro-firms and our notion of formality implies that small firms will have higher costs, are likely to be informal, and will have very high failure rates. Though this corresponds exactly to the standard picture of the stagnant, precarious, unprotected informal worker familiar in the literature, it is, in fact, the opposite.³⁰ It emerges naturally from the workers trying their luck at entrepreneurship (risk taking), often failing, and not engaging in formal institutions until they grow. In sum, there may be nothing pathological about the informal sector firm and its existence may be largely unrelated to questions of labor market dualism or credit market distortions.

Gonzalez de la Rocha (1994) provides a compelling explanation of the life cycle pattern discussed earlier based on the household's capacity to manage these risks. Her interviews show that the heads of young families are more likely to be found in manufacturing while heads of “consolidated” households can move into less onerous but more risky informal service jobs precisely because their mature children provide a hedge against the risk. Further, Balán *et al.* (1973) argue that it is common for workers contemplating opening a firm to maintain their formal sector job until the microenterprise is safely established, perhaps staffed by the wife or mature children, thereby effectively maintaining a diversified portfolio of income streams.³¹ In sum, for workers desiring to become self-employed, there are informal strategies for managing risk.

What is less clear is how precarious life is for those who work for these entrepreneurs as salaried employees. On the one hand, by definition, they are not independent, but are also not covered by most benefits and have

extremely high rates of turnover. On the other hand, as the previous discussion of minimum wages suggests, the sector is not completely without protections and many informal salaried workers are, in fact, family members. In Mexico, evidence on whether total remuneration is lower or higher is mixed, and earnings are not more volatile than those in the formal sector.³² The high rate of turnover may have much to do with the risky nature of microenterprises and where informal salaried employment fits in the life cycle of a worker. The sector appears to serve primarily as the principal port of entry to paid employment for poorly educated youth. The mean age of informal salaried workers in Mexico is five years below that of formal sector workers and 14 years below that of the informal self-employed. Transition data show a high degree of mobility between school, unpaid work and, to a lesser extent, unemployment that suggests a pool of workers not yet tracked into more stable employment. One scenario is that while and just after completing school, many students help out at the family business, and eventually get paid.

Once becoming salaried informal, workers spend on average only two years doing this before moving on to other paid work. The brevity of tenure is similar to the United States where the median tenure for young workers 16–24 years of age is only 1.4 years and 25–34, 3.4 years.³³ Short tenure for young workers might arise for two reasons. First, Balán *et al.* (1973) argue that this period of life for young workers is one of “shopping around” and trying out various possible life choices, and hence they will show short tenure. Second, if Hemmer and Mannel (1989) are correct that in many countries informal small enterprises train more apprentices and workers than the formal education system and the mostly government job-training schemes together, these years to large degree may constitute continued schooling. In this light, the rapid turnover and the fact that 70% of Brazilian informal salaried workers wish to be a formal sector employee (Figure 3) is perhaps not surprising, particularly if it constitutes the second phase of the life cycle model discussed earlier where they seek to accumulate human and physical capital.³⁴ This subsector requires substantial additional research, but its characterization as a stagnant pool of precarious workers rationed out of formal sector employment seems seriously incomplete.

7. ISN'T INFORMALITY LARGELY A WAY FOR LARGER FIRMS TO AVOID PROTECTING THEIR WORKERS?

A recent variant on the dualism view, albeit with different emphasis, sees informalization as an effort by firms facing international competition to reduce legislated or union induced rigidities and high labor costs, particularly through subcontracting production out to unprotected workers.³⁵

Again, this is a topic meriting a longer discussion, but the Mexican evidence suggests that we should approach this hypothesis with caution. Only 20% of Mexican informal self-employed firms report being affiliated with larger firms so subcontracting relations are not the dominant modality of informal firm behavior. Further, Sanchez, Joo, and Zappala (2001), analyzing again the Mexican Microenterprise survey for 1992, 1994 and 1998 find that across the period of trade liberalization and the signing of NAFTA in Mexico, the share of informal micro-firms claiming affiliation with large firms, domestic or foreign in subcontracting relations actually declined. Those affiliated with such firms have higher earnings adjusting for human capital than those not affiliated, a finding consistent with Robles, Saavedra, Torero, Valdivia, and Chacaltana (2001) argument that Peruvian subcontractors offer better working conditions.³⁶ In the early 1990s in Mexico, the earnings of those self-employed who work on a piece work or short-term contract relationship with larger firms broadly tracked those of the independent self-employed across time—rising relative to formal salaried earnings and then falling—suggesting that the logic of these modalities is not so different from that described above. More generally, Bryan Roberts' (1989) interviews with Guadalajara workers suggest that, given the very weak unions and low wages in Mexico, informal relations of this kind are not primarily a strategy for reducing remuneration and worker control over production: “Market uncertainty and the large number of income opportunities in the city mean that it is useful for *both* employees and employers to have flexibility in allocating labor” (*italics added*, p. 48). More generally, it is possible that subcontracting, to the limited degree it appears to exist is not so much a way of avoiding labor legislation, as avoiding the inefficiencies in it discussed above.

8. DOESN'T THE LARGE INFORMAL SECTOR IMPLY LARGE LABOR MARKET DISTORTIONS?

The view that informal workers are queuing for good jobs implies that there are labor market rigidities segmenting the market. Hence, large informal sectors should be a measure of labor market distortions. Global cross-sectional data argue against this view. Figure 5 plots the share of labor forces around the world that are self-employed against formal sector labor productivity in the mid-1990s.³⁷ What is most striking is a clear downward sloping, log-linear relationship, with the poorest Latin American countries having the largest sectors, middle-income countries such as Korea, Greece and Turkey in the middle, and all of the industrialized OECD countries having very small sectors. The Eastern bloc countries, Czech Republic, Hungary, and Poland, are notable outliers, with unusually small self-employed sectors.

To explain this pattern in a traditional dualistic framework would require that poorer countries have progressively more labor market distortion; as I will argue, this is probably not plausible. Instead, let me put together a view that assumes first, no distortions, and second, as argued above, that there is nothing intrinsically inferior about self-employment. Figure 6 offers a very simple view of a labor market that

can help explain the downward-sloping pattern. The two labor demand curves (the marginal product of labor in each sector times the product price) are rotated to face each other. The X -axis represents the total stock of labor. We can think of the informal sector "demand" curve as capturing the effect that, when wages are very low, there is sufficient demand to support a newspaper stand or food kiosk, a photocopy shop or shoe repair shop on every block. As wages rise, the cost of these services rises and they eventually get agglomerated into more centrally located larger stores that are viable at the higher wage. In the absence of any labor market distortions, wages (in reality, utility) in both sectors are equalized and labor is allocated at the intersection of the two demand curves.

As countries develop—crudely conceived of as a rise in salaried sector labor productivity—the demand curve for salaried workers shifts out, the opportunity cost of being self-employed rises, and the very small shop is no longer profitable. Workers are drawn into the formal sector, and the share of self-employment in the overall workforce falls. But, to get the relationship in Figure 5, it must be the case that productivity rises less in the self-employed sector, so that countervailing movements in its demand curve will not, again, increase the demand for labor there. Most observers of the sector would find this plausible, but there is a

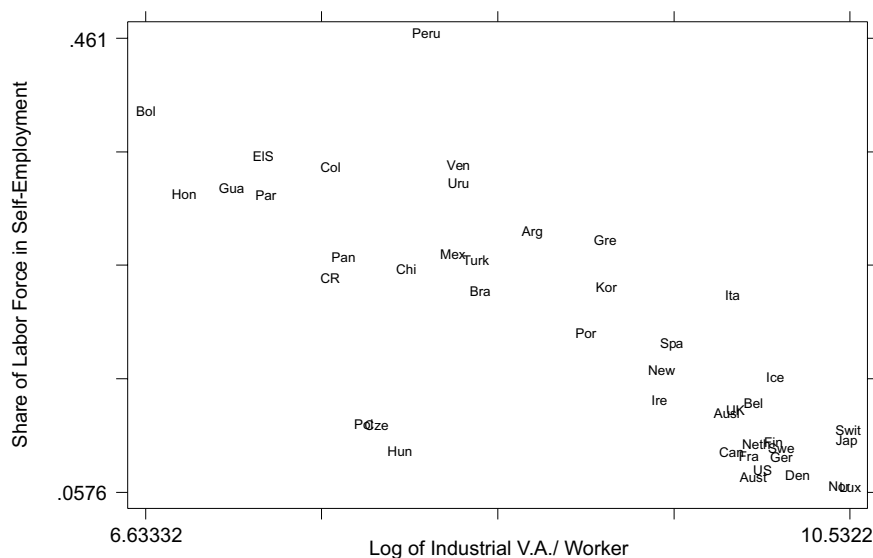


Figure 5. Self-employment and industrial productivity.

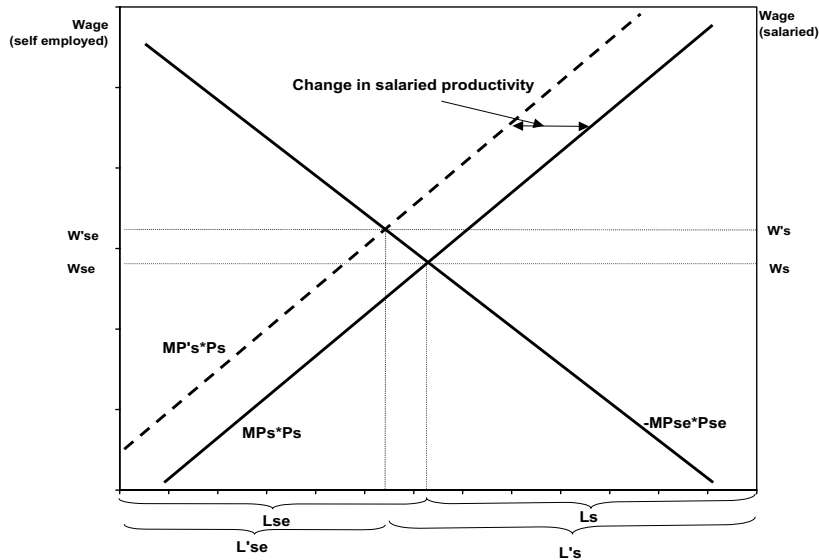


Figure 6. *Informal self-employed and formal salaried sector across the process of development.*

nonpathological reason why this is so: most self-employment is in the service sector and productivity tends to grow less there. Balassa's (1964) estimates of productivity growth in the industrial sectors vs. the services sector for in the United States, Belgium, Germany, Italy, the Netherlands, the United Kingdom, and Japan in the middle of the 20th century suggest that in every case, industry is characterized by higher rates of productivity growth than the service sector: on average, 1.7 times more. It is not so surprising that the service sector in developing countries would show a similar pattern.

This in no way implies, however, that entrepreneurs in the self-employed sector are somehow disadvantaged by these lower productivity growth rates over the longer term. Since wages are equalized between sectors, they benefit from productivity growth in the industrial "formal" sector. Of course, since if we assume that productivity in the informal service sector does not change, then the price of the service must somehow rise to reflect higher labor costs. To translate this relationship into practical terms: It still takes my barber 20 minutes to cut my hair, but now I have to pay him more since the opportunity cost of his time in alternative sectors is higher. This is precisely why haircuts, gardeners, nannies, and all manner of non-traded services are cheaper in the developing world: productivity is lower in the tradable/formal sector. Those familiar with the interna-

tional economics literature will recognize this as Balassa's model of why the real exchange rate, defined as the price of nontradable over tradables, should appreciate with development. All I have done is argue that broadly speaking, the informal self-employed are in nontradable service sectors and the formal salaried are more likely to be in tradable industries.

To be consistent with Figure 5, how large would the labor market distortions have to be to generate the large informal sectors we see in Latin America?³⁸ Labor demand elasticities for formal sector workers tend to have a wage elasticity of somewhere around 0.5: a 1% rise in wages due to a distortion will lead to 0.5% fall in formal sector employment.³⁹ To ration 25% of Mexico's labor force into self-employment compared to, for instance, Luxembourg's of 5%, wages would have to rise above market clearing by 40%—even more if we add in the informal salaried.

These are very significant distortions and they lead to some pretty striking anomalies. The Spanish have a labor market that is legendary for its rigidities, yet the difference between its self-employment share and that of the United States is relatively small. Further, it does not seem possible that LDCs ranging from Korea to Turkey to Mexico are simply vastly more distorted than Spain. In many LDCs, including Mexico, the usual culprits never show up at the scene of the crime. As Bell (1997) and

Davila Capalleja (1994) show, minimum wages are not especially binding in the formal sector in Mexico. This is confirmed by returning to Figure 4, which shows that while minimum wages can be distortionary among workers in the formal sector, as they are to some degree in Brazil and Chile, in Argentina and Mexico they are not and both countries have a high share of self-employed.⁴⁰

Further, recent work by Pencavel (1997) suggests that unions in LDCs tend to be more focused on creating employment than raising wages. Continuing the focus on Mexico, my colleague Eduardo Ribeiro and I (Maloney & Ribeiro, 1999) concur, finding very limited impact of union concentration on wages, but substantial “featherbedding” effects in the manufacturing sector. So, if there are no minimum wage distortions, and no union effects, where are the distortions coming from? It could be argued that nonwage costs are simply very high. But in the absence of nominal wage rigidities, these costs are passed down to workers and should not cause rationing. This is not to argue that there are not many distortions in LDC labor markets, only that there is at least one LDC with a very large self-employed sector where labor market rigidities are not a credible cause, and hence something else must be going on.

Finally, how do we explain the exceptionally low share of self-employment in Poland, Czech Republic, and Hungary? Figure 7 accepts my argument above and strips out the effect of formal sector productivity by regressing the self-employment share on productivity and then plotting the residuals as a measure of deviation from trend. Formal sector productivity, and hence the trend in Figure 5, emerge as statistically significant at the 5% level. The residuals could be considered measures of labor market distortion, given that Spain and Argentina both have their generally acknowledged place as relatively distorted markets and Mexico and the United States stand as examples of relatively flexible markets. But the Eastern European countries are clearly so off trend that it was necessary to include a regional dummy, which is then added to the residual. Strikingly, labor markets in the former workers’ paradise of Eastern Europe appear to be vastly more flexible than those of either Latin America or Asia. This seems implausible, both given history and the fact that open employment was so high during this period. An alternate explanation might be that self-employment is fundamentally a manifestation of individual entrepreneurship that was stifled in the communist system.

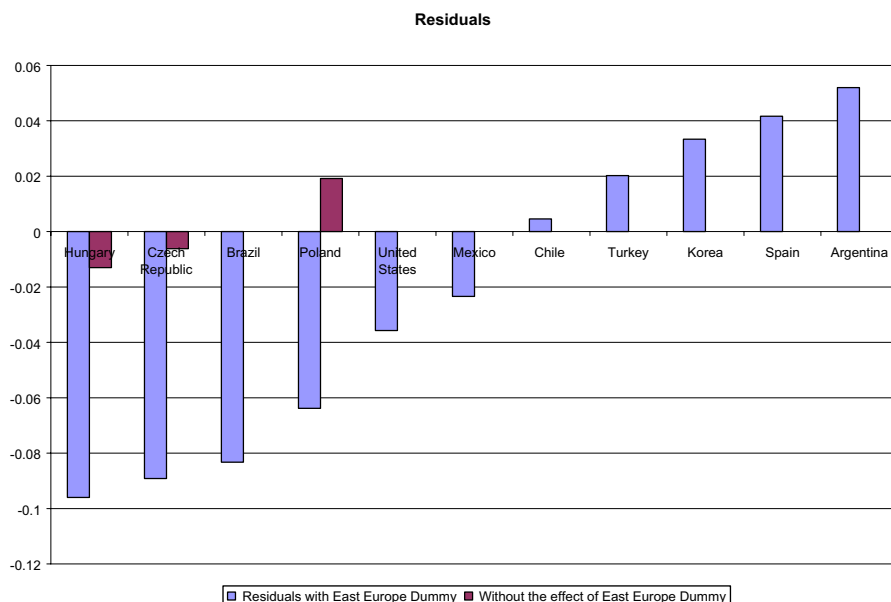


Figure 7. Degree of labor market distortions (residuals of regressions of self-employment on salaried productivity and demographic variables).

9. CONCLUSIONS

The central argument of this paper is that, as a first approximation, the urban informal microenterprise should be viewed as a part of a voluntary small firm sector similar to those in advanced countries that, due to the laxity of enforcement of labor and other codes, is able to choose the optimal degree of participation in formal institutions. The traditional dualistic view can become more relevant in the presence of deep recession and large labor distortions, but acknowledging the generally large voluntary component gives rise to important policy implications that differ sharply from those traditional.

First, if all informal workers were thrown into the sector involuntarily and are disadvantaged relative to those in the formal sector, then virtually any social support to them can be seen as welfare improving. But if many or most are choosing to become informal, then such policies may simply make informality more attractive and shift the labor supply curve to the formal sector to the left. As a simple example, universal basic medical care not linked to other dimensions of formality is implicitly a subsidy to those contemplating leaving formal protections for informal entrepreneurship. Simulations suggest that such subsidies reduce the size of the formal sector and raise the wage that formal employers have to pay.⁴¹

Second, since rational workers will view the entire package of benefits and opportunities offered by various jobs, policy makers must also take a comprehensive view of the social protection system and not treat the informal labor market as an analytical residual to be dealt with as coverage is gradually expanded. Such a view would need to take into account the incentive effects throughout the *entire* labor market of a contemplated policy, its interactions with existing informal support systems that may offer substitutes, and cross effects with other formal sector policies. Some progress in this direction has been made in Lustig (2001) and the works therein make it clear how complex this can be.⁴²

Third, we must acknowledge that formal sector benefits provision in the developing world is frequently extremely inefficient and of poor quality. Because workers pay for these implicitly or explicitly, to the degree that perceived benefits fall short of taxes there is an incentive to evade and to become informal,

particularly where acceptable informal substitutes exist. Rethinking how we can better align benefits and costs of existing programs and how they interact with informal mechanisms should probably take higher precedence than the reflexive expansion of their coverage.

More generally, this logic suggests an important agenda for labor reform beyond the usual focus on wage rigidities driving segmentation: eliminating the inefficiencies in the provision of medical benefits or pensions or biases in promotion systems not based on merit will reduce the incentive to informality and increase the supply of labor to the formal sector. More fundamentally, informal employment in firms of relatively low technology and capital intensity can only be attractive if the overall level of labor productivity in the formal sector is low also. To the degree that current legislation impedes investment in physical or human capital, or prevents the efficient organization and operation of firms, it perpetuates the low levels of productivity throughout the formal economy.

Increasing the size and productivity of the formal sector probably offers the largest hope for raising the standard of living of workers throughout the economy over the longer term. While it is true that micro-firms that participate in business associations, credit institutions, and training institutions or have access to other services are more prosperous, the limited evidence to date suggests that the differences are not dramatic.⁴³ As Figures 4 and 5 suggest, the slow shifting out of the formal sector demand curve and declining share of the informal sector has characterized the development path of the advanced countries and is probably the path that developing countries need to follow as well.

Finally, the poverty observed among today's informal is a function of low levels of human capital and whether the worker is formal or informal is largely incidental. Over the longer term, improving the coverage and quality of education is likely to increase the productivity of the worker and the earnings available in the formal salaried sector. In the short run, however, a worker with few skills that would be rewarded in salaried work may prefer to be independent: S/he may prefer being the master of a lowly repair shop to endlessly repeating assembly tasks in a formal assembly plant. Neither job will necessarily lead to an exit from poverty, but the informal option may actually offer a measure of dignity and autonomy that the formal job does not.

NOTES

1. See Peattie (1987), Fields (1990), Turnham and Eröcal (1990), Tokman (1992), Portes and Schauffler (1993) for excellent overviews.
2. The Harris and Todaro (1970) model is perhaps the traditional statement of this view. See most recently Chandra and Khan (1993), Chandra (1992) and Loayza (1994).
3. See Davila Capalleja (1994).
4. See Maloney and Ribeiro (1999) and Maloney (2001).
5. In a similar vein, the World Bank social protection unit has defined good jobs as those that respect labor standards and operate within the accepted institutional framework. See Canagarajah and Sethuraman (2001).
6. This result holds up if we look at workers transiting into self-employment from the formal salaried sector. This is done by linking the Encuesta Nacional de Micro-Empresas (ENAMIN) with the Encuesta Nacional de Empleo Urbano (ENEU). The ENEU permits following workers over a 15-month period and hence studying their transitions among sectors.
7. These results are very close to Gottschalk and Maloney's (1985) finding that roughly 70% of US job changes are voluntary. Put differently, if self-employment given the common earnings differentials, are close substitutes for formal salaried work, the implied rates of involuntary entry would be normal by the standards of a flexible industrialized country market.
8. Cunningham and Maloney (2001).
9. "It is important to note that 80% of microenterprises consider their situation in the firm as stable and yielding enough to live. This we consider very important, given that the prejudice exists that microenterprises are something temporary, linked to the parallel search for labor opportunities. . ." (Consultora Nordeste, 1998, p. 10).
10. SIEMPRO (1998).
11. Direccion General de Estadistica, Encuestas y Censos, Republica de Paraguay, "Sector Informal," based on the Encuesta Integrada de Hogares 1997-98.
12. Bosch and Maloney (2003) estimate Markov transition matrices for all three countries. They show remarkable degrees of similarity, particularly in patterns of entry into self-employment. See also Fajnzylber, Maloney, and Montes (2003a).
13. See Maloney (1999) and Maloney and Aroca (1999).
14. See Lopez-Castaño (1990) in Colombia, Fields (1990), and Peattie (1982) who find a tendency for employees of large firms to leave and open their own.
15. Using the EM algorithm, we estimated $F \sim pN(\mu_1, \sigma_1^2) + (1-p)N(\mu_2, \sigma_2^2)$ where F is a combination of two distributions of mean and variance 2 weighted by the share of the sector in each distribution, p , $(1-p)$.
16. See Maloney (1998).
17. See Cunningham (2001b) and Katz and Correia (2001) for treatment of Women in the Mexican labor market.
18. Cunningham (2001b). This is also true of home based workers (Cunningham & Ramos, 2001) who have received increasing attention recently, particularly by, for instance, the Women in Informal Employment: Globalizing and Organizing (WIEGO) and the United National Development Fund for Women (UNIFEM), particularly in the context of global production chains.
19. This does not, of course, preclude discrimination against married women or those with children who may be likely to be absent for work for long periods (Chant, 1991).
20. Bosch and Maloney (2003).
21. See Maloney (2001) and Krebs and Maloney (1999) for an elaboration of this view.
22. See Marcouiller, Ruiz de Castilla, and Woodruff (1997) for a recent treatment of wage differentials among sectors in Mexico. Gregory (1986) was one of the first to identify little difference in earnings between the formal and informal sectors in Mexico and, on that basis arguing that job quality was not particularly worse in the informal sector.

23. In fact, theoretically it is not at all obvious that OECD style unemployment insurance systems are appropriate for poor LDC workers. As Nobel prize winner Gary Becker has shown theoretically, in fact, it is not at obvious that many social risks should be pooled at the national level. Those of which occur frequently, but are of limited impact, such as appears to be the case of unemployment in among poor workers in Mexico should be self-insured and the Chilean and Colombian individual unemployment accounts reflect this logic. Going directly to institutionalized pooling has costs, in terms of transactions costs and difficulties in monitoring cheaters.
24. The fraction of household receiving financial help from relatives in other households is 38% in Spain, 11% in Italy vs. 1% in the United Kingdom and 6% in the United States.
25. See Greif (1993, 1998), Portes and Landolt (2000), Glaeser, Laibson, and Sacerdote (2000), Stiglitz (2000), Alesina and La Ferrara (2000). By viewing these institutions as a continuum ranging from informal networks to state institutions, we offer a micro-firm life-cycle analogue to the Stiglitz view of societies evolving from largely informal to more formal institutions.
26. See Cunningham and Maloney (2001).
27. Fajnzylber *et al.* (2003a) find that Mexican firms have mortality rates of the same order of magnitude as those found in the United States by Evans and Leighton (1989), 18% exit to wage work (measured as the fraction of self-employed workers that moves to wage work) compare to 14% across a year. This is consistent with much higher entry rates as a fraction of wage workers, averaging 8% in Mexico compared to the 4% found by Evans and Leighton (1989) for the United States. Among young workers between 28 and 20 years old, failure rates are roughly equivalent at around 50% while for prime age workers, 31–35 years old, failure rates are roughly equivalent at 20%. See also Levenson and Maloney (1996).
28. Saavedra and Chong (1999) more recently have followed up arguing that “Thus, the informal sector can be understood as comprising one group whose decision to stay as independent workers will depend on the agent’s cost-benefit analysis and will no necessarily imply changes in occupations, and another group where the informal sector may somehow represent and option of last resorts.”
29. Using both matching and Heckman style control function approaches, Fajnzylber, Maloney, and Montes (2003b) first, confirm Maloney and Levenson’s earlier pattern of increased participation with firm size and time in business, and second, that those that participate in fact gain. The fact that paying taxes also leads to a rise in income also suggests that at some point, evasion is no longer profitable.
30. This view contrasts with those recently forwarded by Unni and Rani (2003) “Risk to income security for this group tend to derive from the very conditions governing their employment and income generation—that is informality” (p. 130). What I am arguing is that the riskiness is intrinsic to small businesses anywhere and that operation within the accepted institutional framework may be incidental.
31. “The worker in the Fundidora . . . for instance, was extremely cautious when he decided to enter the ranks of the self-employed, after twenty years in the plant. His timing was almost perfect. For five years he had been in the highest position he could expect to attain, so no more mobility could be anticipated within the plant. His youngest son was three years old, and now his wife would be more free of household concerns and could help in the store. He had saved a considerable amount of money during his years in the steel plant. In any even, when he first opened a small shoe store, he did not give up his job in the factory until he was sure of the success of his business venture. He moonlighted in his store for three years, his wife tending it when he was not present. During the first year of operation the store lost money, and in the second year it broke even. At the end of the third year it turned a profit so he decided to leave the factor and devote his full time to the store” (pp. 216–217).
32. See Marcouiller *et al.* (1997) on wages, Maloney, Cunningham, and Bosch (forthcoming) for volatility of earnings.
33. *BLS News*, USDL 92-386 for 1991.
34. In Paraguay the share of informal salaried workers looking for other jobs is only 32% Direccion General de Estadistica, Encuestas y Censos, Republica de Paraguay, “Sector Informal,” based on the Encuesta Integrada de Hogares 1997–98.
35. See Beneria (1989), Portes and Schaffler (1993), and Robles (1989) in the Structural Articulation school, and Reich (1983), more generally in the decentralization school.
36. Robles *et al.* (2001) argue that, in the Peruvian case, micro-firms are largely isolated from the overall

- fabric of Peruvian industry and need to be more tightly integrated.
37. The sample combines data from the OECD surveys, as well as individual surveys from Latin America.
 38. This section adapted from Maloney (2003).
 39. See Fajnzylber and Maloney (2001) for a partial review.
 40. See Maloney and Nunez (forthcoming) for a more complete discussion.
 41. See Krebs and Maloney (1999).
 42. See in particular Rios-Rull and Attanasio (2001) and Hopehayn and Nicolini (2001).
 43. Fajnzylber *et al.* (2003b).

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