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## **Public Policies to Promote Productive Occupation and Increase Formality among the Moderately Poor**

The Mexican Agenda

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### **Abstract**

Public policy aimed at building capacity among the extremely poor (support for food and nutrition; health; education and, more recently, financial services), combined with a stable macroeconomic environment, has proved to be successful for poverty alleviation in Mexico. Even though overall poverty is still very pronounced, about four million people originally in extreme or intermediate poverty registered real income gains during 2000-02 and entered moderate poverty, concentrated mostly in urban areas, where it exceeds extreme and intermediate poverty. Thus, the emerging challenge consists of defining and coordinating specific policies for the moderately poor, whose social and demographic characteristics and economic needs differ from those at deeper levels of poverty. At present, income generation among the moderately poor depends on informal employment, because structural factors impede these workers from participating in the formal sector. To foster social and economic

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Keywords: inequality, poverty, income, education, gender, employment

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development of this group, employment policies in general and policies to facilitate formal activities in particular, stand out as the key elements. Promoting greater formality among the moderately poor requires updating laws and regulations, but equally important, education, training, financial services, technical and administrative assistance for entrepreneurs, etc., must be applied for a sustainable increase in income. The policies should increase formality, which is important for improving income and social protection for the moderately poor; for integrating activities that can benefit from trading with each other, for increasing the competitiveness of the Mexican economy as a whole; for improving political governance and consolidating the rule of law. An integral support programme to raise productivity and income of the moderately poor and to promote their participation in the formal sector activities is outlined in this study.

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## 1 Introduction

Public policies for poverty alleviation have been in place in Mexico for a long time. The nature of these policies has varied over time, ranging from universal subsidies for basic food and consumption goods during the 1970s and 1980s, to targeted income transfers and subsidies for education, nutrition and health during the 1990s.<sup>1</sup> At present, building upon the successful programmes of the last decade, the federal government is pursuing a far-reaching strategy for the permanent reduction of poverty, basically at its deepest levels.<sup>2</sup>

Since the late 1994 crisis, macroeconomic policies have also contributed to poverty reduction by maintaining price stability and a strong foreign exchange rate, preventing real income losses for the population. The combination of adequate macroeconomic conditions and active poverty alleviation policies has been effective. As a result, poverty has continued to decline, returning to levels registered before the crisis.

At the same time, an important change in the extent of poverty has been observed in the country: with the real income of the poorest gradually increasing, many have reached the category of the moderately poor. Moderate poverty, particularly in urban areas, is the most common category contrasting against earlier periods when the most common category was the deeper levels of poverty in rural localities.

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<sup>1</sup> During the 1970s and 1980s, programmes by the *Comisión Nacional de Subsistencias Populares* (CONASUPO) consisted of large-scale distribution of subsidized basic foodstuffs. Over time, due to unrestricted public expenditure during the oil boom of this period, programmes lost their focus on poverty and were extended to non-basic goods and non-poor geographical areas. New programmes were introduced, specifically for the sale of subsidized milk and *tortillas*, but similar problems arose some years later. In the late 1980s, a new programme (*Solidaridad*) was created with a different orientation—the construction of pro-poor public infrastructure in rural and marginal urban areas (schools, clinics and hospitals, roads, water and sewage, electricity, etc.). Later, public spending on macroeconomic stabilization created the need to develop new focalized instruments for poverty alleviation. Since the mid-1990s through the *Programma para la Educación, la Salud y la Educación* (PROGRESA), a new strategy has been in place directed at human capital accumulation among the extremely poor. Efforts also continue to improve the focus of subsidies for public consumption goods.

<sup>2</sup> During the administration of President Fox, PROGRESA was maintained, albeit with a new name (*Oportunidades*), and original policy interventions were enriched with new ones: support to the extremely poor extended beyond basic levels of education to include highschool; improved access to financial services to promote savings among poor households, while income transfers from different federal programme and private migrant worker remittances were simplified through a new network of private and social financial intermediaries; increased finance for the self-employed poor or for productive projects in poor communities by promoting microcredit by non-government intermediaries with the support of federal subsidies. In addition, the geographical scope of *Oportunidades* was widened to include the extremely poor in rural as well as in marginal urban areas. By August 2004, five million households were receiving programme benefits. At the same time, the Fox administration improved earlier public infrastructure initiatives for the extremely poor, by focusing on a well-defined group of about 500 microregions with profound rural poverty. Within this *Microregiones* strategy, government coordination—and financial support for productive activities—is targeted on the provision of integral public infrastructure and services around micro development poles defined within the communities. Moreover, during 2003 Congress approved a law, defining how future social development policies are to be conducted (*Ley General de Desarrollo Social*). Among other things, aggregate federal budgets for social development must not decrease in real terms and social policies must be carried out as state policies, with continuity over time and without political selectivity.

Faced with these trends, Mexico's public policy for poverty alleviation deserves careful consideration. While programmes already in place for the *extremely* and *intermediate poor* need to be maintained and the number of households covered by these programmes enlarged, new additional strategies are needed for the *moderately poor*, whose economic and social circumstances are largely different from those at deeper levels of poverty.<sup>3</sup> Moreover, policies aimed at expanding productive employment for the moderately poor in the context of increasing formality, gain an unprecedented importance in the development strategies of Mexico.<sup>4</sup>

These issues are analysed in this study. Section 2 outlines the recent poverty trends in Mexico. Section 3 compares the characteristics of the population at different levels of poverty and examines the reasons why moderately poor household members engage in informal occupations. Section 4 shows that informal occupation is not the mere residue of low labour-demand situations, but rather a permanent or structurally determined category. The section also analyses how informality is, on the one hand, largely encouraged by a loophole between existing laws and regulations, and on the other hand, by actual employment conditions in certain industries encompassing numerous small businesses. Section 5 presents general observations on the existing legal framework and points the way to reform for reducing informality. Section 6 describes a broad strategy on how to promote employment and incorporate a larger number of the moderately poor into the formal economy. Section 7 offers some final remarks.

## 2 Recent trends of poverty

General poverty trends in Mexico over the decade 1992-2002<sup>5</sup> are given in Figure 1, based on three different poverty line definitions.<sup>6</sup>

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<sup>3</sup> Three levels of poverty are distinguished in this paper: extreme, intermediate and moderate. However, the analysis here is centred around moderate poverty, comparing it against deeper poverty and the non-poor.

<sup>4</sup> Informality is understood throughout the study as employment in the non-structured sector where individuals lack the benefits of labour and social security laws, and seldom pay federal or local taxes. In most cases, these individuals work in informal operations that do not comply with regulations on public health, environment, space use, etc. The largest proportion, by far, is the workers whose social, demographic or economic characteristics prevent them from finding jobs in the larger formal firms and who work in the informal production of goods and services in order to meet the needs of family. Only a minor proportion of total informal employment covers illegal activities (sale of stolen or counterfeited goods, or of merchandise illegally brought into the country). Statistical data presented in the paper are based on definitions of the non-structured sector established in the 1990s by the ILO. Thus, informal occupation here is the total number of the self-employed and those working in very small economic units that ignore current labour and social security legislation. These small or micro economic units (employing usually less than five in the service sector and less than 15 in manufacturing, excluding agriculture) generate income opportunities for business owners and the wage-employed, but also for unpaid relatives who, in lieu of wage remuneration, share in the family budget. Informal occupation comprises these three different categories.

<sup>5</sup> Poverty is estimated in household income surveys with the poverty-line method. These surveys, conducted since 1992 by the National Institute for Statistics, Geography and Informatics (INEGI), are carried out on a biannual basis with the same methodology, which enables reasonably consistent comparisons to be made over time. The last survey refers to 2002 (2004 data becomes available in 2005).

As can be observed, poverty rose considerably in the mid-1990s, after the major macroeconomic crisis late in 1994 induced sharp increases in general unemployment, high inflation and a profound depreciation of the real exchange rate, hitting the poorer population particularly hard.<sup>7</sup> However, after macroeconomic stability recovered in the following years, and also as a result of several poverty-alleviation programmes to tackle poverty at its deepest levels, the country has achieved a period of continuous poverty reduction. Indeed, the number of individuals with per capita incomes under poverty lines A, B and C has dropped noticeably. According to an analysis by the Ministry for Social Development (SEDESOL), based on income surveys from 2000 to 2002, the number of individuals *under* poverty lines A, B and C decreased by 3.1 million, 4.2 million and 20 thousand, respectively.<sup>8</sup>

Nonetheless, two major challenges have to be met with regard to poverty alleviation. First, even though the country has returned to poverty figures comparable to those before the crisis, the extent of poverty is still too large. The number of individuals in 2002 living under poverty line B (in intermediate and extreme poverty) is estimated to be around 26.9 million, or 26.5 per cent of the total population. Both absolute and relative magnitudes must be reduced in the future. Programmes like *Oportunidades* and *Microregiones* must be expanded to cover more households and, therefore, additional government budgets are required. In the context of a balanced public budget to maintain macroeconomic stability, this translates into a significantly greater need for federal revenues, which can be achieved only through a profound tax reform.<sup>9</sup>

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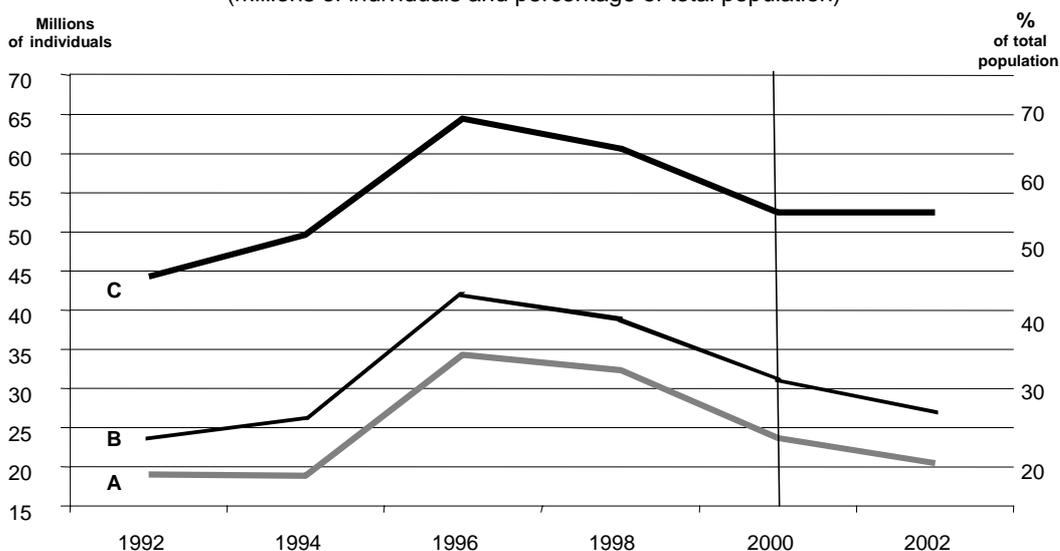
<sup>6</sup> Poverty in terms of households or individuals is officially quantified according to three poverty lines defined in 2002 by the Mexican Ministry for Social Development (SEDESOL). Poverty line A (the severest) is a per capita amount of income barely sufficient to acquire the nutritional basket defined by INEGI and the Economic Commission for Latin America of the United Nations Organization (CEPAL). Poverty line B (between the two poles) corresponds to the level of per capita income just sufficient to purchase the said nutritional basket, plus goods and services related to education and health. Poverty line C (the least severe) is a per capita amount of income which covers the nutritional basket plus goods and services related to education and health as well as clothing, transportation, housing and other basic needs. The extent of poverty is measured by the number of individuals (or households) under each poverty line.

<sup>7</sup> The effect of real exchange rate depreciation on poverty can be understood in two ways. Mechanically, the total number of individuals under poverty lines A and B, and to a some extent also under line C, is affected because nominal income is contingent on wages determined by domestic labour markets and, given the openness of the economy, the cost of the basket of goods and services is influenced by international prices. According to another view from a general equilibrium perspective of a two-sector economy, labour-market competition implies that the more productive workers (with better knowledge and skills) are employed to produce tradeable goods for international markets, with the less educated (usually from poorer households) working in sectors which produce non-tradeables goods and services for domestic consumption (construction, retail commerce, transportation, services, etc.). Thus, the real exchange rate depreciation has an increasing effect on profitability and real income in the tradeables sector, but an adverse impact on non-tradeables, adding to poverty.

<sup>8</sup> SEDESOL defines poverty under lines A, B and C as *pobreza alimentaria* (in terms of food and nutrition), *pobreza de capacidades* (inability to fully enjoy basic functionings) and *pobreza de patrimonio* (inability of households to accumulate any capital), respectively. For analytical purposes, this paper, although based on the same official poverty lines, uses an alternative approach to refer to poverty and terminology: 'extreme poverty' constitutes poverty *below* line A; 'intermediate poverty' *between* lines A and B; and 'moderate poverty' *between* lines B and C. The non-poor have per capita income above line C.

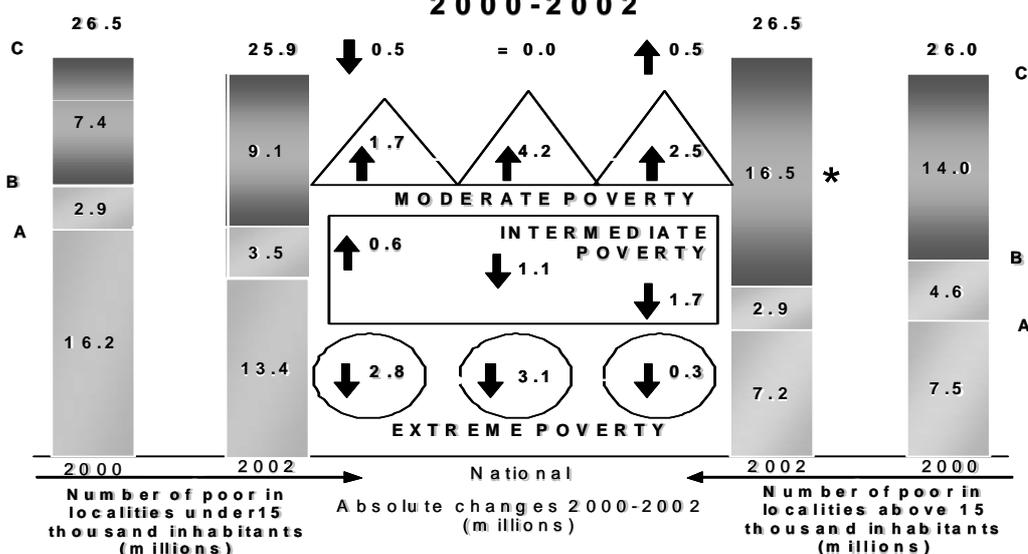
<sup>9</sup> The tax reform debate has been active since the Fox administration. Divergent views on several tax strategies exist in Congress and within society at large, including the possibility of VAT being applied

Figure 1  
Population in different degrees of poverty, 1992-2002  
(millions of individuals and percentage of total population)



Source: Oficina para las Políticas Públicas, with data from SEDESOL

FIGURE 2  
NUMBER OF URBAN AND RURAL  
POOR BY DEGREES OF POVERTY,  
2000-2002



Source: Oficina para las Políticas Públicas, with data from SEDESOL

Second, attention must be paid to the growing numbers of moderately poor and changing geographical distribution. This group has increased recently, as reflected by the widening gap between poverty lines B and C in Figure 1. The moderately poor by

to goods now exempted (food and medicine) with income transfers to poorer consumers to offset its impact. However, progress has been made recently through the *Convención Nacional Hacendaria*, a joint effort of the federal and states governments, to identify viable strategies to strengthen public finance at different government levels. The Convention's conclusions will be submitted to Congress for analysis and eventual legal reform.

2002 totalled 25.6 million, which is equivalent to the total of the intermediately and extremely poor. Or, in other words, moderate poverty currently represents almost half of total poverty.

Figure 2 analyses this in more detail. As can be seen, between 2000 and 2002, the moderately poor increased by a number roughly equivalent to the decrease of the intermediate and extremely poor (4.2 million individuals). This reflects an improvement in the income levels of the poorer sectors which, even though not sufficient to push these to the non-poor category, was enough to move them to moderate poverty.<sup>10</sup> Moreover, Figure 2 also shows that this phenomenon has taken place unevenly in the urban and rural areas.<sup>11</sup> As a result, by 2002 more than half of the total number of poor lived in urban areas, where the observed level of poverty was moderate.<sup>12</sup>

In the face of these trends, public policies for the alleviation of poverty deserve careful consideration. While programmes for the extremely and intermediately poor need to be maintained and expanded, additional new strategies are necessary for the moderately poor, whose economic and social characteristics differ from those at deeper levels of poverty.

### **3 Characteristics of the moderately poor and implications for public policy aimed at facilitating their participation in formal economic institutions**

The purpose of this section is to highlight some distinctive features of people in moderate poverty vis-à-vis those in deeper poverty and those considered as the non-poor.<sup>13</sup> These differences constitute the key determinants of public policy for promoting social and economic development of the moderately poor.

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<sup>10</sup> During 2000-02, others have fallen into moderate poverty as per capita income decreased because of unemployment and real income reductions reflecting the decline in manufacturing, tourism, etc. However, the increasing number of moderately poor is also a reflection of improved real income among the poorer households existing earlier below poverty lines A and B. Despite the declining level of international activity, a strengthening of the Mexican real exchange rate induced real income growth that benefited the domestic or inward-oriented industries (construction, transport, commerce and other services) where most of the poorest non-agricultural workers are employed.

<sup>11</sup> Between 2000-02, the reduction of extreme poverty was most pronounced in rural areas (a decrease of 2.8 million), while the increase in intermediate and moderate poverty was comparatively smaller (0.6 million and 1.7 million, respectively). Thus, the number of rural poor lessened by approximately 0.5 million, dropping to 26 million. In contrast, the opposite is true in urban areas. In localities of more than 15,000 inhabitants, the numbers of extremely and intermediately poor dropped by 0.33 and 1.7 million, respectively, while moderately poor grew by 2.5 million. As a result, the urban poor increased by about 0.5 million individuals, totalling 26.5 million. These differences are largely explained by the varying employment and real income trends of rural and urban industries that are affected by declining international activity and foreign exchange rate appreciation. Extreme poverty declined more in rural areas, and is consistent with the fact that programmes like *Oportunidades* and *Microregiones* are mainly geared for rural regions. The smaller reduction of urban poverty underlines the need for additional new strategies.

<sup>12</sup> This is in sharp contrast to the situation prior to 2000, when more than 50 per cent of the poor were in rural areas, where extreme poverty was commonly recorded.

<sup>13</sup> Households at different income levels can be compared with household income surveys. Standard analysis considers sectors of the population by quintiles or deciles. For simplicity this paper uses the poverty lines explained in footnote 8.

Table 1 summarizes several demographic and educational characteristics of families, calculated as the average of households in each of the three different income groups. Because birth control has been adopted more readily in moderately poor households, the average number of members per household, as well as the average proportion of members aged 0-18 years (although still considerably higher than among the non-poor) is lower in these households than among the poorer families. In comparison to poorer households, the smaller proportion of juveniles in the moderately poor households is also evident in the lower demographic dependency ratio (i.e., the quotient of the number of members aged under 18 or over 65 years, relative to those within this age bracket), although it is still not as low as in non-poor households.

This relatively low dependency ratio among the moderately poor households is important for two reasons. First, it permits these people to accumulate capital over time; they have some potential for savings, as evidenced by the fact that their average dependency ratio (89.2 per cent) favours a smaller consumption-to-income ratio. In contrast, in poorer households the number of dependants exceeds on average the number of productive-aged members (a dependency ratio of 124.3 per cent), thus causing a negligible savings capacity.<sup>14</sup> If the savings potential of the moderately poor is to be stimulated for asset accumulation and greater protection against risk, public policies must ensure that the poor have access to formal financial services and intermediaries that are adequately regulated, in order to offer positive and secure returns on the savings of the poor, given that their scarce resources are usually kept in low-return investments (e.g., livestock or inventories of construction materials for future improvements for dwellings) or in unregulated and risky informal financial institutions.<sup>15</sup>

Table 1  
Average demographic and educational characteristics of households,  
by levels of income, 2002

	Extreme and intermediate (below poverty line B)	Moderate poverty (between poverty lines B and C)	Non-poor (above poverty line C)
Members per household	5.2	4.5	3.6
% of members aged 0-18	50.3	42.5	30.5
Dependency ratio (18-65)	124.3	89.2	57.4
% of households headed by a female	17.5	20.0	21.7
School attendance (% aged 6-18)	80.0	80.1	87.3
% of ages 18-65 with education less than completed highschool	95.5	88.1	63.3

Source: Oficina para las Políticas Públicas and SEDESOL, with data from INEGI (2002)

<sup>14</sup> These effects are even more pronounced when the schooling of productive-aged members is considered. Table 1 shows that this particular age group in the moderately poor households has a highschool education more frequently than in the poorer households.

<sup>15</sup> A new law (*Ley de Ahorro y Crédito Popular*) was approved in 2001 to gradually guide the financial intermediaries typically serving the poor to more reliable and regulated institutions, which would eventually form a banking sector with a social orientation (*banca social* or *banca popular*). This will complement the commercial banking system which until recently has been passive in providing financial services to low-income clientele.

And, second, the smaller number of household members outside the 18-65 age bracket reduces the time required for family care. In a society in which this role traditionally and disproportionately is entrusted to women, the smaller number of dependants in the moderately poor households facilitates greater female participation in non-domestic economic activities. This opens several important avenues for social and economic development of the moderately poor households, since better employment opportunities for women<sup>16</sup> translates into additional income for the family budget (which in many cases will lift these households from the ranks of moderate poverty). At the same time, the empowerment of women through income generation in decent employment accelerates social change and improves gender equity. To facilitate this, public policy must not only focus on the creation of more formal jobs through private investment, but also on the expansion of institutions for the care of children and the elderly. More importantly, as will be outlined later, regulation changes are needed in order to make part-time jobs more attractive for formal-sector employers. This could help to hire women on flexible terms, such as shorter hours or shorter work weeks, and piecemeal employment periods. The relevance of this as a general strategy is even more important, given that one of every five households in moderate poverty is headed by a woman.

Table 1 also presents some indicators on education. As can be seen, the present school attendance of household members aged 6-18—being fairly similar among the

Table 2  
Economic participation, income and asset holdings of households, by income levels, 2002

	Extreme and intermediate (below poverty line B)	Moderate poverty (between poverty lines B and C)	Non-poor (above poverty line C)
Percentage of economically active members aged 18-65	63.3	64.4	70.9
Employed income earners per household	1.8	1.8	1.9
Average income of employed earners in pesos per month	940	1,930	4,950
Per capita income of households	525	1,063	3,412
Mean (above) and median (below) in pesos per month	501	1,016	2,337
No. of rooms in house (bath and kitchen excluded)	2.2	2.5	3.5
Percentage of houses made of durable material	62.9	86.6	94.9
Percentage of households with:			
Motor vehicle	9.2	19.5	47.2
Refrigerator	40.5	73.9	86.3
Washing machine	23.2	47.2	66.4
TV	73.6	93.0	94.2

Source: Oficina Políticas Públicas and SEDESOL, with data from INEGI, ENIGH (2002)

<sup>16</sup> The relevance of this should be noted. INEGI employment surveys show that practically all productive aged men among moderately poor households hold jobs. This is natural, given that tradition in Mexico places the greatest responsibility for income provision on men, so the opportunity cost (marginal utility loss) of having men inactive is too high for poor households. Consequently, additional income for these households can be generated only through a gain in productivity, or through greater participation outside the home by women, who are still economically inactive. Bringing these households into the formal economy is important.

Table 3  
Some average characteristics of economic participation of households,  
by income levels, 2002

	Extreme and intermediate (below poverty line B)	Moderate poverty (between poverty lines B and C)	Non-poor (above poverty line C)
Percentage of economically active members aged 18-65, who are employed	97.4	97.0	97.5
Percentage of the employed aged 18-65 who are self-employed	35.5	23.1	17.6
Average earnings per employed member in pesos per month (1)	940	1,930	4,950
Average earnings per owner or self-employed member in pesos per month (2)	680	1,552	5,461
Ratio of (2)/(1)	0.72	0.80	1.10
Percentage of employees with social security	19.4	43.6	67.3

Source: Oficina para las Políticas Públicas, with data from INEGI-SEDESOL, ENIGH (2002)

Table 4  
Average years of schooling of the employed in different occupation status,  
by per capita household income, 2002

	Extreme and intermediate (below poverty line B)	Moderate poverty (between poverty lines B and C)	Non-poor (above poverty line C)
Paid employees	6.1	7.5	10.7
Self-employed	3.7	5.3	7.8
Business owners	3.5	5.7	10.8
Unpaid workers *	5.7	7.4	8.8

Note: \* These represent household members employed in family businesses headed by a relative but who are not paid a wage directly, sharing, instead, in the common family budget.

Source: Oficina para las Políticas Públicas and STPS, with data from INEGI, ENIGH (2002)

Table 5  
Distribution of employment by occupational status  
and per capital household income, 2002

	Extreme and intermediate (below poverty line B)		Moderate poverty (between poverty lines B and C)		Non-poor (above poverty line C)	
	Male	Female	Male	Female	Male	Female
Paid employees (non-agricultural)	37.5	65.6	69.3	37.4	54.7	69.6
Paid employees (agricultural)	24.8	9.6	3.1	2.2	2.2	0.4
Self-employed	29.1	18.5	16.9	48.0	31.9	18.7
Owners (5 employees or less)	1.9	2.8	6.2	0.3	0.6	2.2
Owners (6 employees or more)	0.2	0.1	1.5	0.0	0.0	0.4
Unpaid family worker	6.1	3.3	2.5	11.0	10.0	8.2
Unpaid worker	0.3	0.1	0.3	1.0	0.5	0.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Oficina para las Políticas Públicas, with data from INEGI-STPS, ENIGH (2003)

moderately poor and poorer households (80 per cent)—is still lower than in the non-poor (87 per cent). To some extent, this is a consequence of the past practice of children and teenagers of poor families dropping out of school to enter the workforce before completing their basic education.<sup>17</sup> It is also, however, caused by insufficient or inadequate access to childcare institutions for the poor, which means that mothers are forced to take small children with them to work. Similar problems existed earlier, with the result that today 80 per cent of the moderately poor household members aged 18-65 have not completed highschool. Even though this proportion is lower than among the poorer families, it is still much higher than among the non-poor (63 per cent).<sup>18</sup> As the competition for formal-sector jobs favours workers with better schooling, the limited accomplishments of the poor puts them at a disadvantage and adds to the necessity of finding a job in the informal sector.

Table 2 presents more details on income generation and capital accumulation. The average rate of economic participation and the average number of employed income earners are not very different among the three income groups. Even if these indicators are slightly better among the non-poor (suggesting less restrictions on access to jobs or greater work effort), this fact is not as important as the differentials in the average income of employed earners. Indeed, average income of an employed earner among the moderately poor is only 39 per cent of that of the non-poor and twice that of the extremely and intermediately poor. Obviously, these huge differentials are related to the equally remarkable differences in productivity, many of which are a reflect of informality. These are explained later in the paper.

The differences in average income per employed earner, in conjunction with the above-mentioned demographic characteristics, explain the differentials in mean and median income per capita. They also account for the contrasting savings capacity among the three income groups. Table 2 confirms the preceding discussion on the savings capacity of the moderately poor.<sup>19</sup>

Table 3, focusing on occupational characteristics, indicates that employment rates do not vary across income groups. The type of occupation more common in each case does, however, differ: self-employment is far more frequent among the poor. In the case of the moderately poor households, one of every four employed individuals is self-employed. For poor household workers, this type of occupation means considerably

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<sup>17</sup> This fact is well recognized; existing poverty alleviation programmes include educational grants and scholarships ranging from primary to highschool levels for poor students. *Oportunidades* is noteworthy among the various programmes, but the *Programa nacional de Becas* (PRONABES) has also provided over 6 million scholarships for highschool or university education.

<sup>18</sup> At all income levels, the share of youngsters and adults without a highschool diploma is very high, posing a major challenge to the country's social development and economic competitiveness. Several adult education programmes have been in place for a long time, but their priority should be increased and supported with bigger budgets, as well as with administrative and technological improvements for an open and flexible education system.

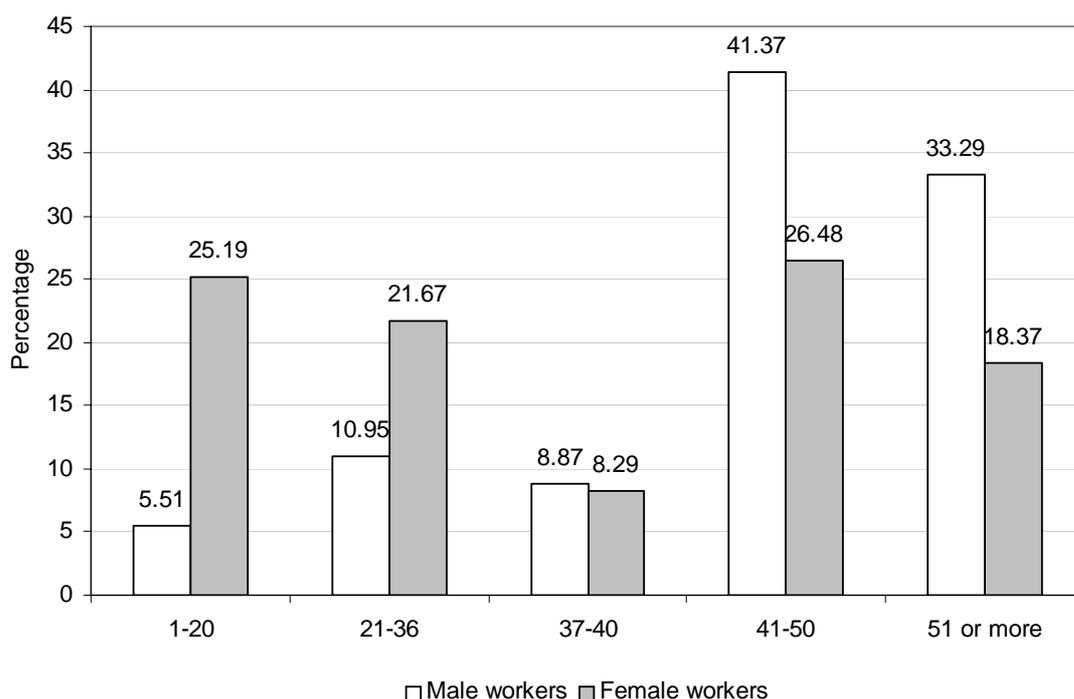
<sup>19</sup> However, the moderately poor are often without formal property rights on the assets they own. The possibility of potentially risky and costly litigation reduces the liquidity of their assets and market value. Efficient means to clearly establish formal property rights is tantamount to giving this group considerable capital gains.

lower earnings; the self-employed from poor households earn between 70-80 per cent of the amount earned, on average, by all workers in the same household groups.<sup>20</sup>

But lower labour earnings are not the only disadvantage of poor households. Protection against risk is relatively rare, as they have less access to healthcare and pensions from social security. The same table indicates that only 44 per cent of the employed members of moderately poor families enjoy social security, compared to two-thirds for non-poor household members. Clearly, access to social security is inversely correlated with the proportion of self-employment among employed members.

The difference in schooling for youngsters and adults among the income groups has been mentioned earlier. However, as Table 4 shows, such differences exist within each group and are linked to the individual's occupational status. The self-employed stand out as the category with the lowest schooling among the three income groups. In poor households, members with better schooling are mainly employed as wage-earners, while the less-educated are the self-employed or business owners. Once more, schooling differentials are found to influence participation in informal productive activities.

Figure 3  
Households in moderate poverty,  
percentage of employment by hours worked per week, 2003



<sup>20</sup> As can be seen in Table 3, the converse is true for employed individuals from non-poor households: the self-employed earn on average 10 per cent more than the wage-employed. Thus, the entrepreneur notion better applies to the self-employed non-poor, while the poor self-employed, even when working independently, are disadvantaged by factors that erode their labour productivity, such as limited capital, less efficient technology, restricted access to affluent product markets, etc. The difference in human capital is also relevant; this point is revisited later.

The gender issue highlighted earlier as the reason of informal-activity employment is also confirmed in Table 5. The breakdown by occupational status of employed members of the moderately poor households indicates that a large majority of male workers are wage-earners (69.3 per cent, agricultural activities excluded), while almost half of the female workers are self-employed and about one employee in ten works without a salary in a family-owned business. Moreover, the share of self-employment is not negligible: it applies to almost one out of every six males in this income group. Employment as an entrepreneur is also considerable among the males from this income group, although it must be noted that this only concerns economic units of five or less employed individuals (6.2 per cent) and seldom applies to units of larger size (1.5 per cent).

The very large proportion of self-employed women is a reflection of the social or institutional factors that constrain their full-time productive activities outside the home, and make it difficult to work as wage-earners in formal businesses. Figure 3 throws more light on this. While 75 per cent of the males from moderately poor households work more than 40 hours per week, the corresponding figure for women is only 45 per cent. Conversely, 47 per cent of women in this income group work less than 36 hours per week outside the home. The constraints against women's full-time participation are an important determinant of informality, since refraining from informal productive activity would take their families deeper into poverty.

In sum, this section analyses several demographic and social circumstances that affect the population's involvement in informal activities. Unless adequate public policies are adopted to cope with or modify these circumstances, informality will persist because it constitutes the only income alternative for large groups—women who cannot work full-time outside the home, and youngsters and adults with limited schooling.

#### **4 Informal and formal occupation: some economic determinants**

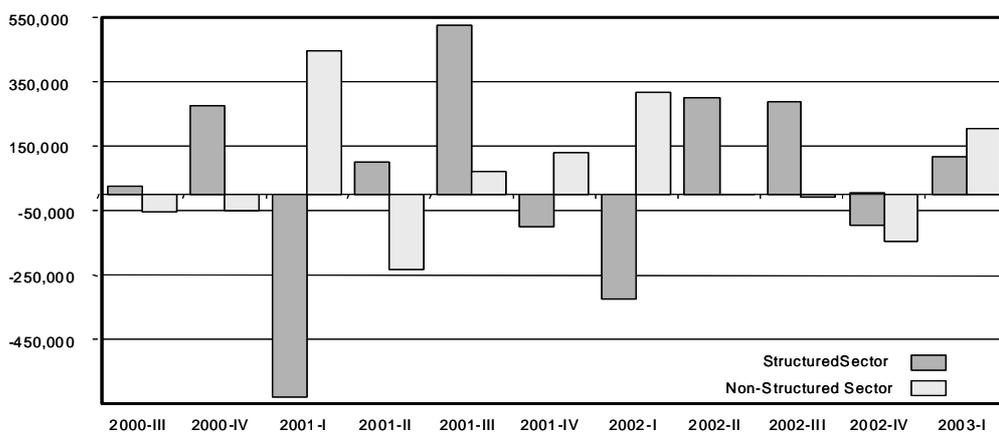
This section takes a deeper look at informality, reviewing the aggregates of formal and informal employment from an economic perspective. Informal occupation is not simply a residual employment category that can be explained by excess labour supply when private investment is insufficient. Rather, the following section offers a different view in which the structural determinants outlined in the previous section also have an important role. Other economic determinants are highlighted in addition to the demographic and social characteristics already discussed.

Figures 4 and 5 compare the simultaneous changes in employment recorded in the structured and non-structured sectors of the Mexican economy,<sup>21</sup> albeit measured over different timespans. Figure 4 highlights the quarterly variations in the number of people employed in each sector versus the preceding quarter, while Figure 5 compares the corresponding variations against the same quarter of the preceding year. The former figure is, therefore, useful for analysing the correlation between formal and informal employment over the medium run while the latter, in turn, helps to understand the correlation between the same variables over short periods of time.

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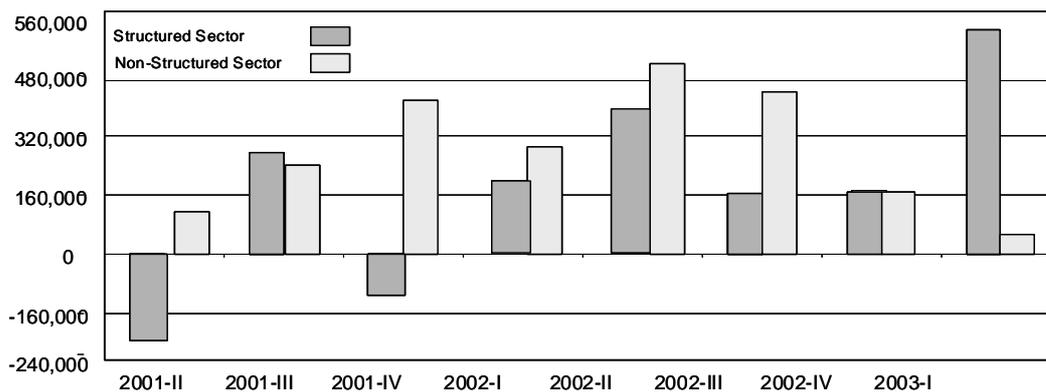
<sup>21</sup> The non-structured sector is synonymous to the informal sector in this paper.

Figure 4  
Short-term variations in employment, structured and non-structured sectors, 2001-II and 2003-I  
Absolute change with respect to previous charter (no. of individuals)



SOURCE: Oficina para las Políticas Públicas, with data from INEGI-STPS, Encuesta Nacional de Empleo.

Figure 5  
Medium-term variations in employment, structured and non-structured sectors, 2001-II and 2003-I  
Absolute change with respect to previous charter (no. of individuals)



SOURCE: Oficina para las Políticas Públicas, with data from INEGI-STPS, Encuesta Nacional de Empleo.

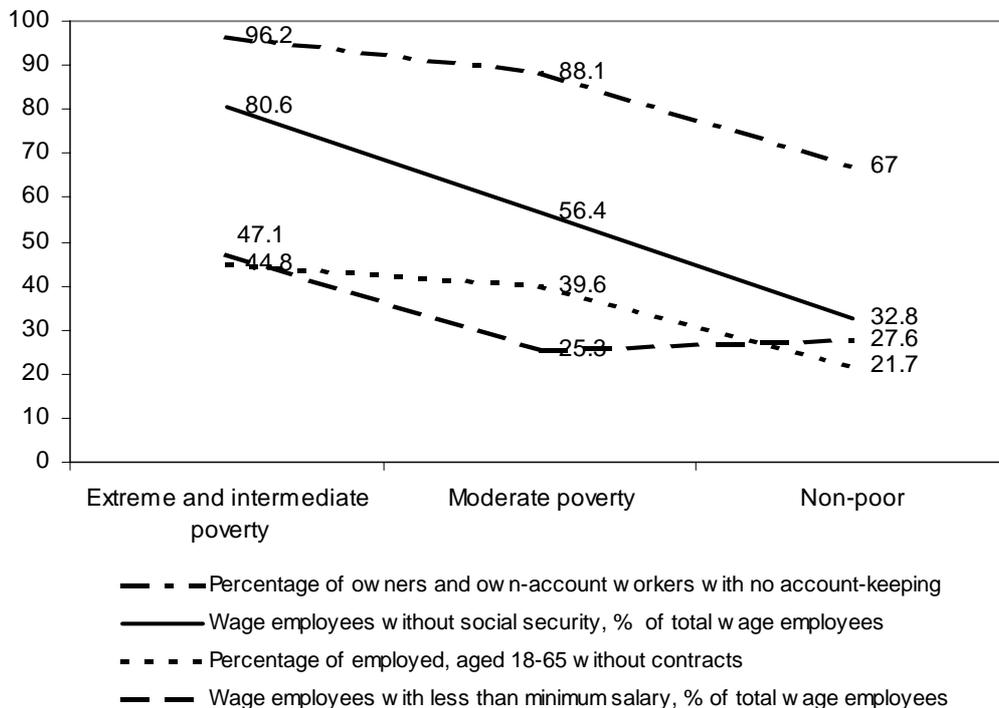
As can be observed in Figure 4, short-term absolute employment trends in the structured and non-structured sectors often have opposite signs, indicating that informal occupation in the quarterly periods usually increases when formal occupation declines, and vice versa. In contrast, Figure 5 shows that changes in the formal and informal employment normally move in similar directions over one-year periods. This indicates that informal jobs appear to substitute formal ones in the short run, while these two types of jobs are complements in the aggregate over the medium or long run.<sup>22</sup>

<sup>22</sup> This can be interpreted in terms of adjustment costs over different periods of time. An application of this approach to private finance is given in Villarreal (1986). Consider, for instance, the case of a firm looking at the problem of financing investment: capital and debt are substitutes in the short run, although they behave as complements in the longer run when the firm seeks to maintain an optimal debt-to-capital ratio due to such structural determinants as risk of bankruptcy and tax deductibility of interest payments.

This phenomenon is interesting, since it encompasses two apparently different conceptions of informal employment. Indeed, the informal sector grows when labour demand in the formal is low, but this reflects mainly a short-run economic behaviour. Informal jobs may be attractive, but only as an immediate and temporal alternative for individuals whose qualifications would enable them to get a formal job later, once the formal labour demand improves. However, this switch from formal to informal jobs does not exist for those individuals who are disadvantaged with regard to access to formal jobs, such as many women who are time-constrained and other individuals with relatively low schooling. Thus, over the medium and long run, even if the labour demand in the formal sector picks up, informal employment will continue to grow if the structurally disadvantaged population continue to add to the labour supply.

Formal and informal jobs are not close substitutes since they are very different in terms of remuneration and protection against such risks as unemployment, health or death. The poor are forced to accept informal jobs more frequently than the non-poor, and are thus in noticeably lower quality jobs, as shown in Figure 6. Among the employed members from moderately poor households, 56 per cent have no social security, compared to 33 per cent for non-poor families. Similarly, 40 per cent of moderately poor workers have no written labour contracts, while this figure is only 22 per cent among the non-poor. These differences are even more pronounced for the extremely or intermediately poor households.

Figure 6  
Some characteristics of compliance with legal norms,  
affecting individuals from poor and non-poor households, 2002



Source: Oficina para las Políticas Públicas, with data from INEGI (2002)

Table 6  
Employment in the non-structured sector, by job position  
and number of employees in the production unit, 2003

No. of employees	Job position				Total
	Employer	Own-account worker	Wage employee	Unpaid worker	
1		3,387,674	17,756	204	3,405,634
2 to 5	885,565	597,337	3,998,699	1,585,046	7,066,647
6 to 10	19,741	6,727	199,386	25,245	251,099
11 to 15	1,062	140	39,477	494	41,173
16 to 50			3,198	134	3,332
51 to 100			351	0	351
101 to 250			416	89	505
251 or more			14,528	3,734	18,262
Not specified			242	356	598
Total	906,368	3,991,878	4,274,053	1,615,302	10,787,601
	8%	37%	40%	15%	100%

Source: Oficina para las Políticas Públicas, with data from INEGI and STPS (2003)

Most jobs in the informal sector are in very small-scale economic units. Actually, 37 per cent of the persons working in the informal sector are own-account workers (i.e., self-employed) and 66 per cent work in units consisting of two to five individuals (Table 6). Only 3 per cent of the informal sector employees are in economic units of six or more individuals.

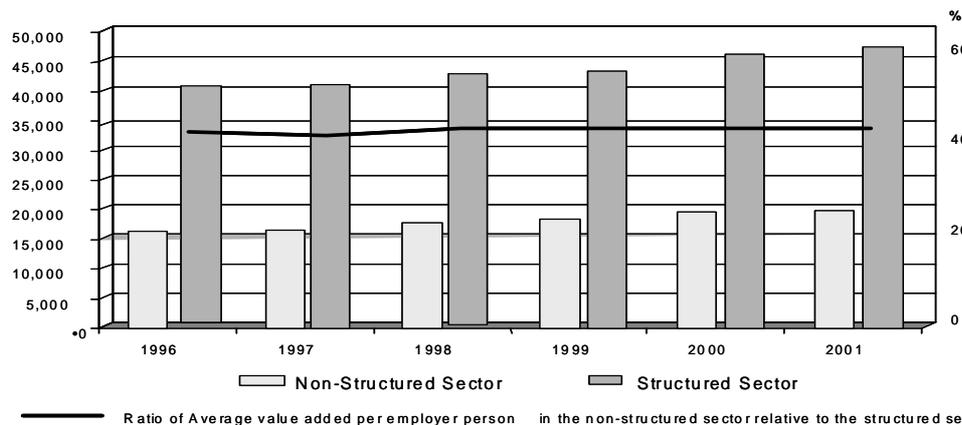
In economic units as small as this, value added per employed person is very low. As can be seen in Figure 7, even though there have been some increases in productivity in both sectors between 1996-2001, average value added per employed person in the informal sector continues to be around 40 per cent of that of the formal.<sup>23</sup>

The income of business-owners or wage-employees, therefore, in the informal sector is relatively low. Figure 8 compares the average profits of owners or the self-employed, and shows that this indicator among the moderately poor households is broadly one-fourth of that among non-poor households. Similarly, looking at the ratio of formal to informal earnings for individuals in retail commerce, transport or construction, Figure 9 indicates that formal jobs pay better than informal ones. Formal jobs in retail commerce result in 35 per cent higher earnings. This ratio is even more marked in transport (60 per cent higher) and construction (70 per cent higher).<sup>24</sup>

<sup>23</sup> The low value added is caused by inadequate factor endowments and technological and managerial deficiencies. Informal businesses market their products among clientele with relatively low purchasing power, mostly poor households in the same community. Marketing in more affluent segments of the formal sector is often inconvenient or impossible, because of the required compliance with regular business standards, such as formal invoices and tax receipts. Trade between the formal and informal sectors faces this restriction, with the consequence that micro businesses are not efficient suppliers for the formal sector and efficiency levels on the whole are less than what would potentially be possible if informal-formal sector trade were more frequent.

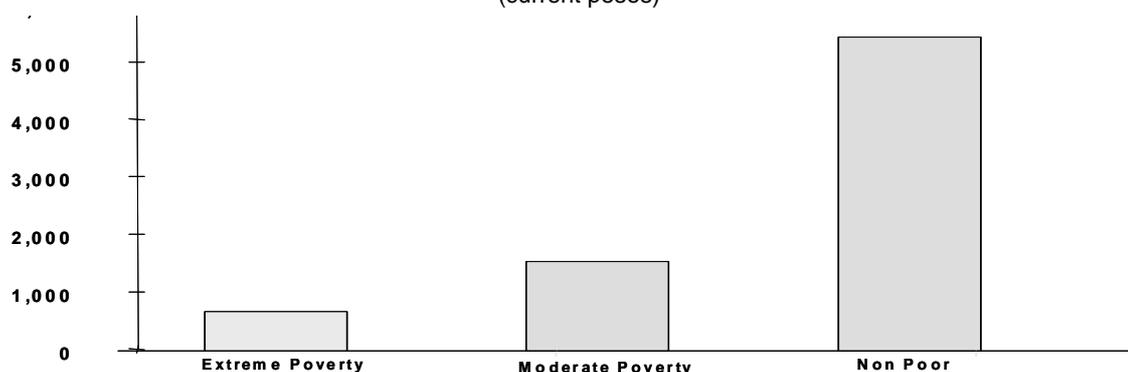
<sup>24</sup> These earnings differentials are seldom recognized in public, since informal activities are often considered synonymous with illegal dealings which can be extremely profitable. However, in normal circumstances informality means smaller incomes.

Figure 7  
Average value added per employed person in the structured and non-structured sectors, 1996-2001  
Constant pesos of 1993



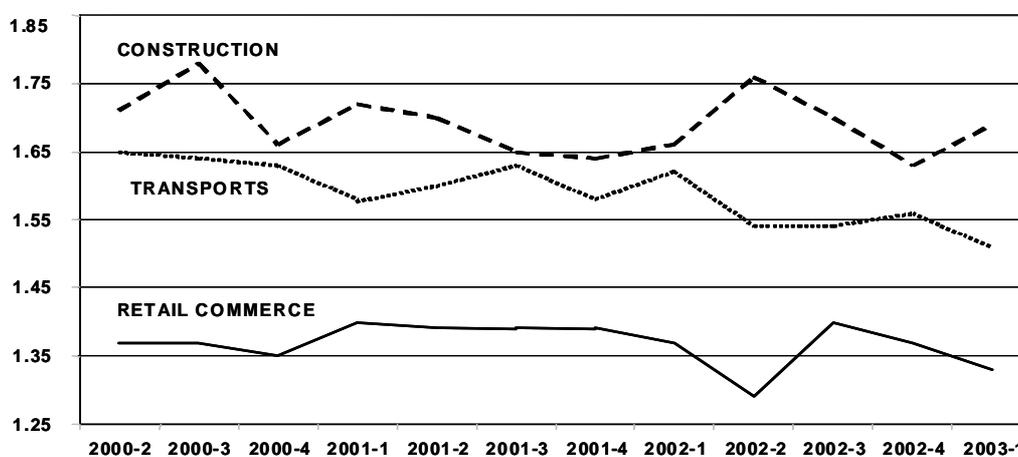
SOURCE: Oficina para las Políticas Públicas with data from INEGI-STPS, Encuesta Nacional de Empleo (ENE) e INEGI, Sistema de Cuentas Nacionales de México, Cuenta Satélite del Sector Informal de los Hogares.

Figure 8  
Average monthly profits per owner or self-employed, by household income groups, 2002  
(current pesos)



SOURCE: Oficina para las Políticas Públicas, with data from INEGI-STPS, Encuesta Nacional de Empleo 2003-I y Encuesta de Micronegocios 2002.

Figure 9  
Ratio of average income per employed person in the structured and non-structured sectors  
in selected economic activities, 2002-03



SOURCE: Oficina para las Políticas Públicas, with data from INEGI-STPS, Encuesta Nacional de Empleo 2003-I y Encuesta de Micronegocios 2002.

If informal jobs imply lower incomes and less protection against economic or health risks for the individual, as indicated, why do workers stay in these jobs? Figure 10 gives some insights into this matter, to be elaborated in section 5.

Consistent with Table 6, Figure 10 indicates that roughly 10.6 million people work in the informal sector. More than three out of every four are employed in retail commerce, a large variety of services, construction, food stalls in the streets and other activities. A review of these industries confirms that not even larger production units translate into lower costs per unit of output; in other words, the economies of scale are low or insignificant. Therefore, competition within similar markets does not result in a concentration of total output in the limited number of production units. Rather, total output is produced by a multitude of small-sized enterprises (each industry often comprising thousands of units, totalling millions in the aggregate, each with one or two workers collaborating with the owner): a myriad of small productive units that are market-efficient and survive in a monopolistic-competitive environment.<sup>25</sup>

This setting is propitious for the widespread non-compliance of applicable legislation (labour, social security, taxes, etc.) for two reasons. It is practically impossible for enforcement authorities to supervise that laws and regulations are effectively observed in millions of economic units (many of which do not operate at fixed locations). And, at the same time, it is not practical for workers to set up small unions in order to force businesses to comply with the laws which could benefit the employees.<sup>26</sup> Compliance is costly, and is not put into practice by the vast majority of small production units. Informality is the current trend.<sup>27/28/29</sup>

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<sup>25</sup> Transaction costs for consumers (e.g., transport and storage costs) may encourage small units to spread out geographically in order to maximize the limited monopoly available in the local neighbourhoods. In this setting, small businesses benefit from a certain degree of natural market protection that enables them to endure lower productivity and maintain jobs for those with less human capital. But wherever transactions costs are small, competition is intense, as barriers to entry in the informal sector are negligible (requirements regarding capital, technology, specific human resources, licenses or permits, etc. are not sufficient to create an entry barrier). Consequently, the spread of informality is contingent on the magnitude of the transaction costs: decreasing these would reduce informality.

<sup>26</sup> Workers, owners and relatives in small production units in Mexico tend to develop close personal relationships based on social networks within the community. Thus, it is natural for these people to prefer to enforce agreements in the familiar production/social setting rather than in the comparatively more formal juridical institutions. (For example, the fact that written employment contracts are seldom used in micro businesses does not imply that the worker-owner relationship is not controlled, or that it could clash at any time against the legitimate interests of the parties. The relationship is usually based on the values and principles of the community and these help to maintain it within efficient and fair limits. Recourse to administrative or judicial authorities is applied only in extremely controversial situations.) In other words, economic contracts in the informal sector are maintained through non-codified rules existing within the community. This explains why workers in small businesses are reluctant to form unions; the more appropriate method of coping is usually on social grounds rather than formal juridical ones.

<sup>27</sup> In contrast, in Figure 10 the informally employed are much less frequent in industries with some degree of economies of scale (e.g., manufacturing of metal products and machinery; food processing, beverages and tobacco; wood products, textiles, apparel and shoes), where one in every four workers is informally employed. The two explanations given above as to why informality is widespread in industries with no significant scale economies are also relevant here: supervision of legislative compliance is easier within a limited number of firms, while in medium-sized firms, employees are

Figure 10  
Employed in the non-structured sector by economic activities, 2001-03

		10,246,727	10,535,975	10,594,188
		2001-I	2002-I	2003-I
Sectors with insignificant scale economies and inward oriented 8.0 millions (77%)	Others	1,355,240	1,383,680	1,409,550
	Food preparation in streets			
	Services	1,790,499	1,889,030	1,877,681
	Retail commerce	3,062,662	3,207,432	3,237,509
	Construction	1,575,900	1,586,138	1,641,974
Sectors with noticeable scale economies and open to international trade 2.4 millions (23%)	Others			
	Metal products and machinery			
	Wood			
	Food, beverage and tobacco	711,871	783,090	791,788
	Textiles, apparel and shoes	701,763	653,777	608,400

SOURCE: Oficina para las Políticas Públicas, with data from INEGI-STPS, Encuesta Nacional de Empleo, 2003.

Industries in which these benefits are applied (and which thus exhibit less informality) must maintain higher productivity in order to offset the expenditure with additional revenue. Higher productivity is partly the outcome from scale economies. But it is also generated through workers with more human capital. And higher productivity is also created when production is better organized with optimized procedures that ensure higher capital-labour ratios. For these reasons, it is natural that informality is less evident in industries where some scale economies exist; in industries that have more capital and better educated workers,<sup>30</sup> and also in industries where full-time employment is fundamental to efficiently performed, optimized production procedures. These elements together constitute the prerequisite for formality and their absence is likely to generate informality.

unionized which helps to observe laws beneficial to workers, making informality relatively rare in these industries.

- <sup>28</sup> Informality is far more obvious in industries with limited scale economies—those usually oriented toward domestic markets—and accounts for the impact real exchange rate has on the size of the informal sector. Here, real appreciation increases profitability, enlarging the informal sector. Conversely, a real depreciation stimulates export-oriented sectors in which economies of scale are more common, reducing informality. Thus, the real exchange rate has a key role, posing once more the classical policy dilemma: exchange rate depreciation stimulates growth through export-oriented industries, but increases poverty and informality (as well as inequality, given that the labour income between the tradeable and non-tradeables sectors widens).
- <sup>29</sup> Figure 10 indicates that the divergence in informality of different sectors argues against the notion that informality is explained by the determination to coerce the application of existing laws since it is difficult to accept that these factors are selectively present. Assumptions of cultural differences across industries or varying existence of corruption in distinct activities have little conviction.
- <sup>30</sup> Better education is believed to promote greater formality simply because more human capital generates higher productivity which in turn helps to absorb the costs of legislative compliance. Moreover, it is also true that educated individuals are more willing to live according to the rule of law.

In the next section, several observations are made on a possible legal reform that would reduce informality. The considerations are based on a realistic evaluation of the social and economic characteristics of production activities performed in millions of very small economic units.

## **5 Some considerations on how to bring informal production activities under an adequate legal framework**

The high concentration of informality in industries where scale economies are not significant clearly indicates that existing laws and regulations (on labour matters and social security) are considerably more difficult to observe in small businesses than in large ones. Economic constraints<sup>31</sup> limit the productivity of micro businesses, making it difficult to absorb the costs related to existing legal requirements.

This non-compliance with legislation may be explained by the fact that the core of the existing legal framework was designed and enacted in the mid-1900s, when the economy was commonly perceived to consist almost entirely of sufficiently large productive units which would enable regulations to be applied without extraordinary enforcement costs. However, the following decades demonstrated that the economies of scale do not apply in many industries and the enforcement costs of the legal framework are disproportionately large. More important, there are significant differences across industries, which makes enforcement feasible only in industries where large firms are common, but seldom in other sectors where small firms are the majority. In other words, differences in the capacity to cope with the costly legislation, as well as the diverging enforcement costs, have resulted in the legal framework being observed in one part of the economy, but not in another. As the legal framework does not recognize these differentials, informality exists and will continue to do so. Furthermore, informality increases in absolute dimension in conjunction with population and economic growth. From the outset of market entry, numerous small productive units face obligations they cannot meet; the existing legal framework is ineffective for these production units.

The disadvantage of this situation is twofold. On one hand,<sup>32</sup> the state cannot efficiently enforce its laws. And to the extent that the population perceives the legal framework as inequitable (similar obligations on productive units, regardless of size or social, technical and economic characteristics), many individuals do not feel compelled to observe rules considered to be unfair. This reduces both legislation enforcement and compliance: when the rule of law erodes, the associated political and juridical institutions are also weakened. This diminishes the capacity of the state to adequately harness the social and economic energies of the country.

On the other hand, small productive units operate under permanent legal uncertainty. Even though it is unlikely that existing laws and regulations are applied to these units, the risk does exist, and could imply potentially large sanctions. Faced with this uncertainty, the self-employed as well as owners of micro firms and entrepreneurs, are

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<sup>31</sup> In this paper, micro businesses and small economic units are synonymous.

<sup>32</sup> About 10.6 million individuals in Mexico are employed in the non-structured sector. The total working labour force is almost 40 million, which means that around one out of every four is without the protection of existing laws.

reluctant to commit more effort or resources. This situation does not improve productivity; it merely stagnates income.

In sum, there are strong reasons to propose legal reform to overcome these fundamental problems. To reduce informality and bring all economic units under a common equitable and efficient legal jurisdiction, the labour and social security legislature must be redefined with particular reference to small productive units, as highlighted by the experience of the last decades.<sup>33</sup> The aim should be to adequately promote a dynamic and fair process of social and economic development based on the productive efforts of the population. New juridical rules are needed for small production units to establish a fair balance of rights and obligations for both the owners and workers, but to also provide adequate incentive for productivity as well as guarantee certain minimum economic and social institutions for all parties concerned with small production units.

Technically and politically this should be feasible if the circumstances of almost 11 million workers involved in productive activities currently not regulated existing laws and regulations are weighted.

## **6 A strategy to overcome moderate poverty and informal occupation**

Considering that about one-fourth of the Mexican population suffers from moderate poverty and that nearly the same proportion of the employed labour force works under informal conditions, the country is faced with a challenge. It needs to adopt effective public policies to overcome these development problems.<sup>34</sup> Some proposals put forward by the Office for Public Policies in the Executive Office of the President are described in the next section, building on the diagnosis presented earlier in this paper. The proposals add to an integrated strategy to reduce moderate poverty and informal employment in the upcoming years as well as encourage entrepreneurship in the context of consolidating formality. The steps in the agenda to put this strategy into practice are explained below, with the aid of the graphic summary in Diagram 1.

The strategy consists of two parts: a government programme to provide support for micro businesses and an improved legal framework to induce greater formality within economic units.

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<sup>33</sup> The design of the legal reform should recognize the fact that in many aspects Mexico's labour and social security legislation today assumes asymmetries between business owners and workers in terms of resources, income and the capacity to bear risks. Owners are compelled, through an array of costly obligations, to secure worker wellbeing. These obligations can be handled by sufficiently large productive firms, but seldom by the small ones that are already hindered by a paucity of public policy to improve their productivity (access to financial services, efficient regulations, support for continuing adult education and labour training, etc.). Indeed, asymmetries are less obvious in small production units and the ultimate distribution of costs and risks must be weighed carefully, so as not to impose an excessive share on business owners, which could provoke informality and, by implication, create negative incentives for entrepreneurship. Care should be taken to ensure that legal reform for redistributing these costs within small firms does not erode the minimum social protection needed in today's modern society.

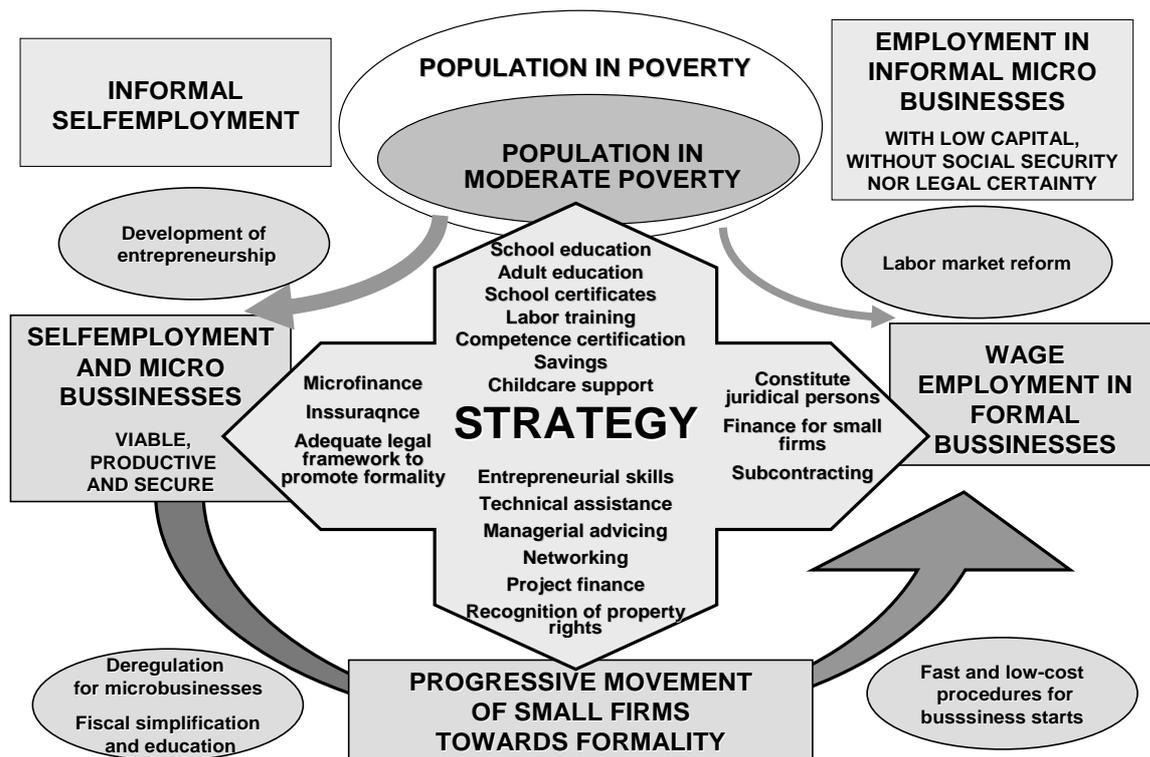
<sup>34</sup> Consider the argument in footnote 24. The importance of reducing informality can be compared to that of liberalizing trade between two similar-sized economies. Mexico has free trade agreements with several countries with economies of less than a quarter of its own economy. Thus, the gains from facilitating trade between formal and informal sectors can be perceived as relevant on quantitative grounds, as would be the advantages of a more strict adoption of the rule of law.

## 6.1 Integral support programme

The integral support programme would combine several lines of action, which converge to increase both productivity and the income of the moderately poor households, while providing them with certain protection against risk and, at the same time, facilitating their entry into the formal sector. Many of the components of the envisaged support programme have been applied in Mexico in the past, but without much coordination. In this sense, the programme does not introduce new policy interventions, but rather stresses policy coordination to achieve significant synergies in the application of the different policy instruments.

The mode of delivery of the services or benefits through various components of the programme would be explicitly strengthened, by establishing efficient administrative procedures and one-stop models of access by those living in moderately poor urban areas.<sup>35</sup> Access to the programme would be based on the self-selection of the individuals, rather than on the bureaucratic evaluation of their circumstances. Thus, programme services and benefits should be tailored to create sufficient motivation among the moderately poor households to apply,<sup>36</sup> but not to attract unwarranted petitions from non-poor households.

**DIAGRAM 1**  
**STRATEGY TO PROMOTE ENTREPRENEURSHIP AND FORMALITY IN MICROENTERPRISES**



<sup>35</sup> In the future, the programme could also be extended to rural areas.

<sup>36</sup> To encourage participation, applications would be processed according to streamlined rules so that the procedure becomes more transparent, and that the unnecessary administrative requisites which extend the selection period are avoided. An overhaul of the administrative processes as well as the introduction of quality control among the relevant public officials is necessary, in order to generate a receptive attitude among the public, particularly since subsidies would not constitute the predominant element of the programme.

The strategy is founded on the promotion of productive occupation for moderately poor household members in order to sustainably increase their family income. As shown in the upper part of Diagram 1, the majority of the working members of these households are self-employed or in very small business that ignore labour laws, social security and taxation issues.

Given insufficient schooling, only a minor proportion of these individuals can find wage-jobs in the formal sector. To increase access to formal jobs, the support programme (the central part of the diagram) would include adult education to increase human capital and their chances of being hired in formal firms. With the same purpose, but looking ahead to future generations, the programme would also involve educational training for school-aged family members. Moreover, it is recognized that schooling is often the screening element used by employers. Thus, to promote awareness among prospective employers of qualified applicants, the programme will also foster the acquisition of official certificates that attest to worker competence for those with previous experience but limited education. Complementing this, the support programme will also include labour training.

This support for human capital accumulation in the moderately poor households will not only propitiate better access to formal jobs, but will also fundamentally increase the productivity of household members, enabling them to generate larger income, regardless of whether they are in short-term informal jobs or self-employed. Income growth in these households should stimulate higher savings. The importance of financial services in this connection is also acknowledged in the programme through the promotion of formal financial intermediaries with adequate regulation<sup>37</sup> to encourage deposits from moderately poor households and grant them credit.<sup>38</sup>

To facilitate greater female participation in the labour force, support for childcare is to be expanded. This should be done not only through economic measures, but ideally also through an improved legal framework to induce regulated formal services for individuals from the same moderately poor communities.

In addition to the support for human capital accumulation already mentioned, the programme considers several options for the self-employed or those occupied in micro businesses, to increase their productivity and security. Financial restrictions constitute a big obstacle for increasing productivity in micro businesses since they impede the improvement of capital-labour ratios from very low levels. Therefore, one of the most important elements of support is access to credit and, specifically, microcredit, from formal intermediaries. The emphasis is on the availability of credit, rather than the subsidization of applicable interest rates.<sup>39</sup> This is a key element, since moderately poor

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<sup>37</sup> To induce competitive interest rates and to protect private savings.

<sup>38</sup> Many social or private financial intermediaries regulated under the *Ley de Ahorro y Crédito Popular* grant microcredit to low-income families with little or no collateral, often requiring the applicant to hold a savings balance. Thus, the emphasis given to savings is twofold: savings leads to larger capital accumulation and protection against risk, while at the same time facilitates access to credit in some form in the formal financial market.

<sup>39</sup> At present, poor families obtain short-term microcredit from numerous specialized formal intermediaries. Nominal interest rates range between 6-9 per cent, with inflation close to 0.3 per cent per month. Real interest rates are high, although still considerably lower than those applied by informal intermediaries, and the large majority of credit holders service debts punctually; portfolios of overdue credits are small.

households seldom have access to commercial banks and must rely on relatives and friends for credit or from very expensive informal intermediaries. Public sponsored microcredit programmes would be modernized and incentives introduced to encourage a transfer over time to financial instruments offered by development and commercial banks, as beneficiaries become more competitive and formal.

Another action line for micro businesses or the self-employed is access to different kinds of insurance: life and health insurance against the risks of interruption of labour income flows; property insurance (automobiles, housing, etc.), to avoid eventual patrimonial losses; and so on. A range of insurance instruments by public or private firms would be offered to these individuals, matched to their particular needs and economic circumstances. To ensure that insurance remains accessible for the people, the menu would include only basic protection in order to avoid costly or inefficient over-insurance. Thus, the programme in this respect would consist of the provision of information and assistance for identifying and contracting adequate insurance, as well as negotiating for group-insurance suppliers for reduced rates for programme participants.

To promote small businesses to shift to the formal sector, the programme also encompasses the deregulation and simplification of government administrative procedures with regard to licenses and permits; start-ups of new businesses; tax payments, and so on. A simpler, less discretionary and more transparent set of regulations and administrative procedures will decrease costs for small economic units and reduce the possibility of abuse or corruption by the authorities. Federal as well as state and local issues have to be considered, and collaboration among the different levels of government is required. The federal government would negotiate with local authorities to get the best method of advancement in exchange for active promotion of the support programme in the respective jurisdictions.

To support the growth of businesses gradually entering the formal sector, the programme includes technical, administrative and juridical assistance for micro businesses; dissemination of information within the small business networks or alliances with larger firms for subcontracting or other collaboration; project finance,<sup>40</sup> including public warranties to facilitate commercial bank credit; support on formal recognition of property rights for valuable assets such as housing or vehicles, to help family-owned businesses capitalize,<sup>41</sup> appointment of juridical personnel to separate business capital from the owners' household patrimony; and other similar actions.

## **6.2 An improved legal framework**

The existing legal and regulatory framework on labour and social security matters applicable to small production units would require reform to realistically recognize the

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<sup>40</sup> While microcredit is appropriate for small informal businesses, project finance is important for formal businesses, as it offers longer repayment periods and more resources than microcredit. Furthermore, project finance is based on an explicit business plan while microcredit is commonly granted on the basis of the applicant's reputation.

<sup>41</sup> Legally secured property rights are essential because they eliminate uncertainty of ownership of assets and thus increase their market value, as costs associated with risky litigation are minimized; the sale of assets brings in more capital for investment in the business. Assets with clear property rights can be used as collateral on loans for financing production.

business environment of these units. Various-sized firms in different business environments would continue to operate under existing legislation, but a special regime could be introduced for small businesses, based on the observations noted in section 5. The legal initiative should aim to promote entrepreneurship and propitiate formality among small businesses. Granting favourable treatment for micro economic units to simply lower their high transaction costs from market or legislative obligations is not enough. Ideally, the improved legal framework should introduce between owners and workers a more efficient and equitable distribution of these costs. The initiative should also prevent the abuse of market power against the small economic units by larger firms, particularly by the commercialized distribution chains. Simplified tax regimes have to be offered, to ascertain the long-term continuity of applicable rules and procedures, and to keep compliance costs low as well as preserve the transparency of such regimes.

New reforms on particular aspects of certain laws, in turn, would have to complement the initiative so as to minimize factors that negatively affect hiring of workers, specially women, in the formal sector.<sup>42</sup>

## 7 Final remarks

Compliance with laws and regulations is important. Fundamentally, each enacted law should be obeyed; the fact that a law has been enacted should be enough to entail strict adherence. In this sense, laws constitute a corpus on their own; they are abstract entities to be honoured *per se*. From this viewpoint, informality, or non-compliance to existing laws, represents anomalous behaviour that should be immediately and automatically contained.

The paper adopts a different approach. Laws and regulations are understood as the means to achieve society's established goals by harnessing individual efforts so that these converge to achieve the goals. Laws are effective when they provide the right incentives for individuals to behave in a socially desirable manner. But if the right incentives are lacking in certain marginal groups, informality arises. In this context, to eradicate or significantly reduce informality, laws need to be amended so that the specific circumstances of marginal groups where informality is dominant can be recognized.

To address the informality related to productive employment, the legal framework on labour and social security must be redefined with the small productive units in mind. The experience with micro businesses over the last several decades is an invaluable starting point. This implies replacing existing rules with new ones which would adequately promote a dynamic and fair process of social and economic development, based on the productive efforts of the people.

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<sup>42</sup> For example, nowadays the existing social security system does not recognize differential premiums which could be applied to a second family member when one member is already contributing to health insurance plan which covers the entire family. Thus, the 'double' payments by members of the same household add unnecessary costs, both for the worker and employer, discouraging to some degree formal labour demand and participation. Commonly men will be the first to enter the labour force, and the elimination of these redundant fees could lower costs for employers, and encourage the hiring of more workers which, in many cases, will be women.

Reducing informality is important for improving the income and social protection of the moderately poor; integrating sectors of activities that would benefit from inter-sector trading in order to increase competitiveness of the Mexican economy as a whole; improving political governance and consolidating the rule of law. Benefits will not only be won on pure juridical grounds, but most importantly, also on economic, social and political aspects as well. Thus, public policy to reduce informality is an integral part of the development policies needed in a modern society to raise the income and security of its members permanently.

An appropriate legal framework along the directions suggested in this paper will reduce informality over the medium and long run. To move faster toward this goal in the short-term, a support programme like the one described in section 6 is relevant.

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