

The Legalist Approach to the Informal Economy:

An Affirmation of Universality

Part One

Introduction

Scholars, politicians, and economists alike are devoting increasing attention to the informal economy. For better or for worse, its sheer magnitude evidences that the informal economy is a significant determinant in the economies of the developing world. Statistically, informal employment constitutes approximately one half to three quarters of employment in developing nations; more specifically, 48% of employment in North Africa, 51% in Latin America, 65% in Asia, and 72% in Sub-Saharan Africa.¹ Additionally, the large majority of all new jobs are generated in the informal economy. In 2002, the International Labour Organization (ILO) reported that “over the next decade, the world’s labor force is projected to increase by 500 million workers, 97% of whom will be in developing countries.”² Based on these statistics, more workers will enter the informal economy than the formal. Thus, the informal economy is an integral factor in devising development solutions.

Some economists conceive the informal economy as a culture produce feature. Others see it as safety valve that filters workers into alternative employment when the formal economy cannot produce sufficient employment to support them. This view treats the informal economy as a kind of insurance against poor economic climates. Both of these perspectives are generally positive.

However, a majority of development economists believe that the informal economy is an exploitative system that needs to be eliminated or reduced in some way. Spearheaded by Peruvian economist Hernando de Soto, the Legalist interpretation perceives that the informal economy is not only exploitative, but also leads to economic stagnation and is an impediment to

¹ Martha Chen, *The Business Environment and the Informal Economy: Creating Conditions for Poverty Reduction*, report. Cairo, 2005.

² *Decent Work and the Informal Economy*, report no. VI. International Labour Organisation, 2002, 94, <http://www.ilo.org/public/english/standards/relm/ilc/ilc90/pdf/rep-vi.pdf>.

development. De Soto proposes that the informal economy is a response to overregulation by the state which poses excessive costs and barriers in accessing the formal economy. He claims that

the answer is to change our legal institutions in order to lower the cost of producing and obtaining wealth and to give people access to the system so they can join in economic and social activity and compete on equal footing, the ultimate goal being a modern market economy, which, so far, is the only known way to achieve development based on widespread business activity.³

The legalist approach to achieve formalization is relatively universal in nature.

Importantly, de Soto does recognize that "...as similar as the developing world's extralegal sectors might be, fundamental legal reform cannot take a cookie-cutter approach; one size does not fit Tanzania, Egypt, and Mexico."⁴ This signifies to applying a nuanced and context specific approach towards the informal economy within the general framework of increasing property rights and reforming bureaucracy.

This approach begs the question of whether such an approach is appropriate to universally apply to the diverse array of developing nations. Could there be cultural preferences that lead people to work in the informal economy by choice?; or cultural reasons that prevent this program from being as efficacious when pursued outside of a Peruvian, Latin American, or Western influenced context? This paper intends to prove that in fact the Legalist approach to reforming the informal economy is appropriate to employ in developing nations regardless of individual culture. To do so, the structure of informal economies with differing cultural backgrounds is analyzed. It concludes that spontaneously generated indigenous extralegal systems that mimic the functions of the formal legal system and the fluidity of movement between those that work in the formal and informal economies demonstrate a close association between the values produced in the two economies and prove that culture is not the reason that

³ Hernando de Soto, *The Other Path: The Economic Answer to Terrorism*. New York: Perseus Books Group, 2002, 244.

⁴ "The ILD Program," Instituto Libertad y Democracia, <http://www.ild.org.pe/whatwedo/program>.

the informal economy persists. Instead, it is the high entry costs and legal barriers to accessing the formal economy that explain the expansion of the economic phenomena, characteristics that are present in all developing economies. Based on this reasoning, as long as formalization programs are implemented in a nuanced and contextually suitable manner, the legalist approach is an effective way to achieve development in developing nations.

Most studies on the informal economy concentrate on theoretical predictions or are based on economic models. There are few that analyze the structures and norms that govern it, and those that do concentrate on single country cases or countries from the same region. This paper is, as yet, the only attempt to look at the organization of multiple informal economies from differing cultural contexts in a comparative way and in a way that examines the cultural components of the informal economy based on their actual manifestation and not founded on simplistic cultural stereotypes or clichés.

Structure

This paper is divided into two sections. The first part will discuss the legalist argument concerning the costs and benefits of the informal economy and its effect on development. It will begin with a definition and description of the informal economy, including its relationship with the formal economy. Then the economic, political, and social impact of the informal economy is explained with examples from the Peruvian case. Peru was chosen as the example case because de Soto constructed his legalist approach in the context of the reality of the Peruvian informal economy and as a result it proves one of the most in-depth and oldest studies of the informal economy. Lastly, the desirability of formalization and an examination of the role for government intervention in the informal economy are presented.

In part two, the appropriateness of the universality of the legalist approach is explored. The case studies of Tanzania and Egypt, along with evidence from Peru, are used to prove that conditions common to all informal economies are conducive to formalization reforms. The extralegal law system and mobility of workers between the formal and informal economies are used to prove this point. Finally, the paper concludes with policy suggestions on how to best implement formalization programs in a sustainable and effective manner.

Definition and Description of the Informal Economy

The informal economy is referred to by several different names, including the informal, hidden, shadow, and parallel economy. It is difficult to precisely define it because of its constant expansion and evolving nature. One way to define the informal economy is to describe the activities that take place in it. For the purposes of this paper, the informal economy is considered to include non-agricultural activities that occur outside a legal framework, but are not criminal in nature.⁵ These activities are either completely unregulated or insufficiently regulated by the state, and are therefore not officially recorded or counted in GDP measurements. Because of the broad nature of the definition, “street vendors in Bogota, shoeshine workers in Calcutta, garbage collectors in Cairo, textile waste recyclers in Manila, homebased garment workers in Buenos Aires, and homebased electronics workers in West Yorkshire” are all components of the informal economy.⁶ These activities take place in more unconventional areas than formal ones, such as private homes, streets, and unregistered shops and factories. Although informal activities occur in both urban and rural environments, their manifestation is different in accordance with the requirements of the location.

⁵ Omar E. Garcia-Bolivar, *Informal economy: is it a problem, a solution or both? The perspective of the informal business*. Northwestern University School of Law, 2006, <http://www.bg-consulting.com/docs/informalpaper.pdf>, 2-5.

⁶ Jon Frost, *Returns to Qualification in Informal Employment: A Study of Urban Youth in Egypt*. Ludwig-Maximilians-University, 2008. http://mpira.ub.uni-muenchen.de/12599/1/MPRA_paper_12599.pdf.

A second way to define the informal economy is by examining its work force. There are three general categories of employment in the informal economy: employers, the self-employed, and wage workers.⁷ Employers are comprised of owners of informal enterprises and owner-operators. The self-employed are heads of family businesses, own account workers, and unpaid family workers. Wage workers consist of employees of informal enterprises, domestic workers, casual employees with no fixed employer, homeworkers, and temporary and part time workers.⁸

There are many conflicting opinions on the relationship between the formal and informal economies. Depending on the school of thought, the relationship is described as a complete integration of the economies or a total separation. Legalists acknowledge that there is a connection between the two, but that the relationship is exploitative. For example, formal businesses often subcontract some aspects of production to the informal economy where they can pay informal workers lower wages and benefit from the cheaper cost of production. The chart on the next page further classifies the differences of the nature of the formal and informal economies.

⁷ Martha Alter Chen, Renana Jhabvala, and Frances Lund. *Supporting Workers in the Informal Economy: A Policy Framework*. Publication. ILO Task Force on the Informal Economy, Nov. 2001. <<http://www.wiego.org/papers/policypaper.pdf>, 7.

⁸ Ibid.

Characteristics		Formal sector	Informal sector
Nature of the firms		<ol style="list-style-type: none"> 1. Registered, large, corporate firms. 2. Specialized firms. 3. Domestic and/or foreign ownership. 4. Large-scale production. 5. Jobs are permanent and full-time with high rate based upon formal labor contracts. 6. Profit maximizing firms, with limited tax evasion. 7. Main goal is capital accumulation. 	<ol style="list-style-type: none"> 1. Unregistered, micro, small units/registered firms. 2. Diversified units. 3. Mainly family enterprises. 4. Small-scale production. 5. Permanent self-employed, non-remunerated family individuals, seasonal and part-time wage-employed. 6. Income-generating firms, with nearly full tax evasion. 7. Mostly the main goal is work absorbers.
	Technology	<ol style="list-style-type: none"> 1. Sophisticated technology (modern). 2. Use advanced tools and skills. 3. Production based on intensive capital. 4. Requires formal education. 5. Imported inputs. 	<ol style="list-style-type: none"> 1. Utilization of outdated technology. 2. Simple tools and low skills. 3. Production is labor intensive. 4. Learning by doing. 5. Local inputs.
Factor market	(input)	<ol style="list-style-type: none"> 1. Access to raw material may face barriers. 2. Employees are subject labor legislation. 3. Access Availability of both local and foreign financial institutions with fairly low interest rates. 4. Transaction may be made on credit. 	<ol style="list-style-type: none"> 1. Easy access to raw material as they are from the surrounding local environment. 2. Workers are not subject to labor legislation. 3. No access to any financial institution and rely on self-financed, or informal credit with high interest rates. 4. All transactions are made in cash.
Output markets		<ol style="list-style-type: none"> 1. Barriers to entry. 2. Oligopolistic firms. 3. Products are standardized. 4. Government organizes markets via tariffs, import licenses, etc.) 5. High return to both human and physical capital. 	<ol style="list-style-type: none"> 1. Easy entry. 2. Competitive firms. 3. Products are not standardized. 4. Markets are left alone. 5. Low return on money and capital.

Sources: Suarez-Villa (1987), Naritoku (1988), LaBlanc (1991), Thomas and Vallejo (1991), Gupta (1997), UN (1997).

Costs and Benefits of Acting Informally

Benefits

Again, Legalists view the informal economy as “a rational response by micro-entrepreneurs to over-regulation by government bureaucracies.”⁹ These workers turn to illegal methods not to act against society or by choice, but to survive.¹⁰ People base their decision on whether or not to enter the legal system and remain there based on a broad assessment of what it could cost to comply with legal requirements and what they could gain from doing so.¹¹ Access to the formal economy is essentially barred because of high entry costs and entry barriers. Acting outside of the law becomes the only option available to the poor because it is more beneficial for them to break the law since the cost of following it is greater than the benefits. However, if entry costs and access barriers are not considered, there are very few benefits associated with the informal economy. Those few benefits include easy entrance, minimal capital investment, and maximization of labor, the poor’s only real asset.¹²

Costs

Sources of the Problem

Legalists identify two main obstacles that create the high costs and entry barriers to accessing the formal economy: excessive bureaucracy and a lack of property rights. The former creates costs and barriers in respect to becoming formal, while the later imposes penalties for those who remain in the informal economy.

⁹ De Soto 1992, cited in Chen, 9.

¹⁰ De Soto 1992, 11.

¹¹ Ibid, 133.

¹² Alter Chen, 14-15.

Property rights, and the tools it generates, such as contracts, stock shares, patent rights, bonds, bills of exchange, and promissory notes, are legal tools that create the basis for a modern market economy. In fact, legal property rights are the single greatest tool in generating wealth and creating a sustainable market economy.¹³ By representing the relationship between people and property, property rights can be used as a way to generate capital, create enforceable agreements, and establish trust to encourage economic transactions through the elimination risk. They are codified, standardized and represented in documents, which form the basis for “...titles, stocks, and share certificates, [they] create property; guarantees create capital and credit; identity documents create identities; adjudication decisions create ownership; authorized signatures and fingerprints create level of authority; statutes create companies; contracts materialize commitments; proxy forms create delegates, and so on.”¹⁴ Documents allow people to establish relationships beyond their immediate community and function in a more spatially and organizationally complex environment. Therefore, lacking property rights also means lacking a tool essential for capital accumulation and expanding business relationships.

Excessive bureaucracy means that one must comply with a large number of laws and regulations. Following these laws could take hundreds of days, cost thousands of dollars, and require visits to dozens of offices. The regulations are intended to correct for imperfections in the market and provide for better planning of public and private activity. In practice they create high entry costs that discriminate against poorer sectors and protect wealthier groups that have stronger legal protection.¹⁵ Consequently, legal protection becomes a privilege and informality a

¹³ De Soto 1992, xxv.

¹⁴ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis*. Instituto Libertad y Democracia, Sept. 2005, http://www.ild.org.pe/files/Tanzania_Volume_I.pdf, 8.

¹⁵ De Soto 1992.

popular response that somewhat successfully breaks down the legal barriers to economic participation.

Economic Costs

The economic disadvantages of joining the formal economy can be broken down into entry barriers, which concern the costs of leaving the informal economy and officially registering a property or business, and maintenance barriers, which include the costs a formal enterprise acquires by continuing to function formally.

Entry Barriers to the Formal Economy

Entry barriers are unnecessary costs of formality that derive from laws that impede or disrupt economic activity.¹⁶ They are complicated, time consuming, costly, and intimidating, especially for people of humble means. The cost of formalizing a business in 1983 Peru best exemplifies this concept. De Soto's think tank, the Instituto Libertad y Democracia (ILD), conducted a simulation for legally registering a garment factory, a widespread activity in Peru that also involves 90% of the requirements that all single proprietor enterprises must follow to legalize. The simulation exposed that it took over 289 day to comply with 11 bureaucratic procedures. In terms of expense, each procedure cost \$194 and over \$1,000 in profits were lost in time spent on completing formalization activities rather than working. Additionally, authorities requested 10 bribes, 2 of which could not be avoided in order to progress to the next procedure in the process. The total costs of the formalization effort represented over 32 times the monthly living wage.¹⁷ These barriers and costs are simply too excessive for a common person to assume and demonstrate the insufficient incentives to formalize. Unfortunately, the regulations that

¹⁶ De Soto 1992, 132.

¹⁷ Ibid, 134.

create these barriers discriminate by wealth. Larger enterprises and wealthier individuals have more capacity to absorb costs and are able to hire legal representation to aid in cutting through the red tape.

Barriers of Remaining in the Formal Economy

An enterprise's relationship with the law continues for the duration of the activity because it must abide by additional regulations to remain legal. These costs are imposed directly by the law through taxes, compliance with bureaucratic procedures, regulation obligations, and high rate payments for public utilities.¹⁸ Firms accumulate expenses because they have to devote employee time to complying with regulations, and consequently waste money on wages not devoted to increasing profits. 40% of administrative employee time (and thus, 40% of salaries) was spent on completing bureaucratic requirements in Peru.¹⁹ There are also indirect costs produced by legal institutions in the form of instability of the legal system, insecurity of property rights, and an inefficient judiciary. In Peru, these costs amounted to an average of 347% of after tax profits, implying that a company could almost quadruple its profits if it did not have to comply with the regulations.²⁰

The cost of remaining formal affects potential profit and reinvestment because it prevents surplus from being freely distributed. As a result, the firm is further hurt not only because potential profit is suffering, but also since reduced investment affects future operations and output.²¹ An enterprise's success is determined by laws rather than its own efficiency, distorting natural economic law.

¹⁸ Ibid, 146-147.

¹⁹ Ibid, 148.

²⁰ Ibid.

²¹ Ibid, 151.

Disadvantages of the Informal Economy

Even with the great costs and barriers associated with formalization, choosing informality is in no way liberated from cost penalties. In fact, while entry barriers are completely eliminated, costs rise exponentially. One obvious complication of countries with large informal economies is the segmentation of markets, with capital more available in the formal economy and labor more abundant in the informal.²² The result is a distorted economic reality where the cost of labor is more expensive in the formal economy and capital more expensive in the informal. Formal businesses rely too heavily on technology and fail to take advantage of Peru's most abundant factor of production (labor). On the other hand, informal businesses suffer from underinvestment, which stunts their growth and quality standards. Legislation that creates entry barriers is responsible for producing "an arbitrary and inefficient specialization of a country's resources" because it divides markets in ways that do not allow for the optimum combination of inputs.

This phenomenon, known as the Theory of Labor Segmentation, also creates a wage hierarchy. Formal employees earn more than informal ones, even when doing the same work, because "rewards in different economic sectors differ for workers of equal potential productivity."²³ This occurs in part because informal employers do not have to comply with minimum wage laws. Also, informal tasks are typically more poorly paid because they are often unskilled or involve the earlier stages of production. Furthermore, workers have no stable guarantee of work and fewer opportunities for advancement. As the graphic below illustrates, these factors mean that poverty is much more prevalent for informal workers, which constitute a considerable portion of the total workforce. Although formal employment is desirable because

²² Ibid.

²³ Douglas Marcouillier and Leslie Young, "The Black Hole of Graft: The Predatory State and the Informal Economy." *American Economic Review* 85 (1995): 367-368.

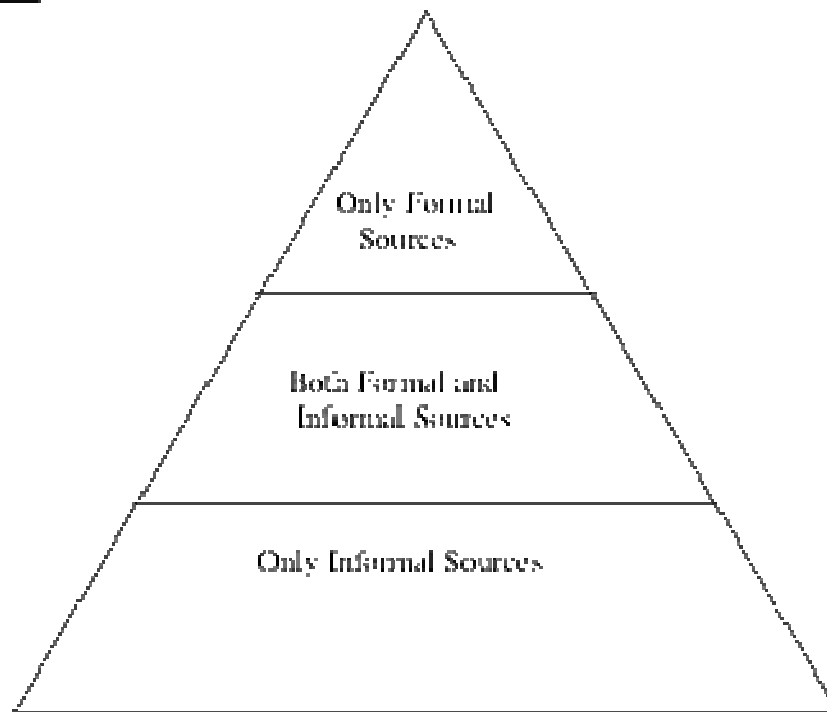
the risk of poverty is diminished for formal workers, there are very limited opportunities to find work in the formal economy because of high costs and entry barriers. Therefore, the lower wages of the informal economy help to trap the poor in a perpetuating cycle of poverty.

Poverty Risk

Low



High



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One issue particularly related to the lack of property rights is the difficulty informals have in using their property as a mechanism to generate capital. Property needs to be transferable, meaning that it can be sold, rented, or used as collateral to back loans. It is impossible to convert property into a factor of production without property rights to define ownership of the property, and legal instruments, such as contracts, to establish legal agreements concerning the property (i.e. loans).²⁵ Because informals have no legal means to prove ownership, they cannot use their

²⁴ Chen, 25.

²⁵ De Soto 1992, 25.

homes or other forms of property to access credit. Moreover, additional mobility issues arise when an owner of a business or dwelling leaves or dies. Without property rights, housing cannot be inherited and business activity ends when the owner leaves.

With little or no access to formal credit, informal businesses are severely undercapitalized. Informal credit is available but unappealing because of the exorbitant interest rates. For example, in 1985, Peruvians could purchase informal credit at interest rates of up to 22% a month, while the formal interest rate never rose above 4.9%.²⁶ Additionally, there is little incentive to invest in informal businesses and homes because of the risk that the state or another agent will take them away.

Informality also provokes substantial costs from defending possession and avoiding penalties.²⁷ Bribes the severely cut into profits are one avenue to protect property. In Peru, informal businesses expended 10-15% of gross income on bribes, while formal businesses pay less than 1%.²⁸ Taxes are often cited as a deterrent to formality, but bribes frequently exceed the value of taxes. Furthermore, bribes serve no social purpose, while taxes fund public services.

A second way businesses elude penalties is through deliberately limiting their operation and dispersing employees so that only small numbers work together in the same location.²⁹ By doing this, enterprises lose productivity because they relinquish the ability to achieve effective economies of scale. In order to disguise informal activities, informal business operators are prevented from entering certain markets. This is another form of confining their operation by limiting their market power and, consequently, profit potential.

²⁶ Ibid, 156.

²⁷ Ibid, 159.

²⁸ Ibid, 154.

²⁹ Ibid, 153.

Lastly, informals are prevented from using advertising in order to hide their activities; instead they must rely on reputation.³⁰ The U.S. Small Business Association explains that advertising is responsible for generating 2/3 of commerce.³¹ Enterprises suffer from a reduced customer base because they cannot rely on advertising to compensate for a poor location or low visibility. Again, avoiding penalties comes at the expense of increasing a business' market share, growth, and profitability.

Property rights yield other forms of organizational instruments that provide the basis for advanced economic relationships. Contracts, stock shares, and limited liability, among others, are important concepts that allow individuals to pool resources of multiple people to benefit one enterprise. They create guarantees and define ownership in an enforceable manner by “establishing rights and obligations among a number of parties within an operating framework which permits inputs to be pooled on a productive and long term basis.”³² Without such guarantees, collective ventures are vulnerable to manipulation and exploitation, and therefore, too risky to enter. The overwhelming majority of informal businesses are single proprietorships because it is impossible to establish guarantees strong enough to mitigate these risks.

Single proprietorships do not eradicate the risk of conducting business without legal instruments. They are constrained to conducting economic dealings through family, friendship, or regionally based networks because it is difficult to construct trust between strangers with no backing coersive mechanism.³³ Meaningful and reliable long term relationships and trust between actors take many years to establish and maintain. However, even in long term relationships, the informal economy provides no guarantees. It is also difficult to leave these

³⁰ Ibid, 154.

³¹ Ibid.

³² Ibid, 169.

³³ Aili Mari Tripp, *Defending the Right to Subsist: the State vs. the Urban Informal Economy in Tanzania*. Working paper no. 59. Wider, 1989.

relationships after they lose their economic advantage because of the personal connections and lack of alternatives involved. Again, the benefits of competition are eliminated because informals are forced to operate within a set group of actors. Newcomers to an industry experience higher than average costs because they lack these networks and a reputation, and consequently are charged higher prices to mitigate this risk. In contrast, legal economic tools allow for relationships of trust to be instantaneously created and provide actors with more options.

The tools generated by formal property rights permit the ability to plan long term financial and economic strategies. Enterprises cannot make the necessary long term investments in machinery, establish prolonged with suppliers, and provide long term employment contracts without information about expected demand and guarantees on future production. Informal enterprises yet again forgo the benefits of optimal economies of scale, growth, and employment stability.

Informals make a number of unreciprocated transfers to the formal economy through indirect taxation, inflation, and differences in interest rates.³⁴ Thus, they lose utility from their money. For example, informals must pay taxes on goods acquired from the formal economy, while informals benefit from purchasing tax free formal goods. This goes against intuition and the principles of economic equality because the informal poor are essentially gifting relatively large subsidies to the wealthier informal economy. In 1985, an amount equal to almost 4% of Peru's GDP was transferred to the formal economy. The government then uses this money to provide public services to those who can formally access them, excluding the majority of people active in the informal economy.

³⁴ De Soto 1992, 155.

Although actors in the formal economy benefit from net transfers, they also assume a number of burdens imposed by the informal economy. The chief burden is their role as supplier of the tax base; the tiny proportion of the population that comprises the formal economy is responsible for funding the nation's entire budget. Additionally, informals gain access to public utilities by stealing them from formals. Formal enterprises and households must pay extra fees to shoulder the burden of the stolen goods. Finally, they also are responsible for bearing the costs of complying with formalization requirements. Formals mitigate these damages by demanding privileges from the government, which in turn continues the discrimination of poorer enterprises and encourages informal activity.³⁵

The state also confronts obstacles posed by the informal economy, with its primary difficulty being the formulation of an comprehensive economic strategy. Official estimates of the informal economy are often inaccurate and do not provide an accurate analysis of its impact on the formal economy. Furthermore, it has no representation in GDP or other national economic indicators. In Lima alone informal markets generate \$41 million a year and street vendor sales total \$33.2 million, all of which goes unrecorded. Since informal activities constitute such a large percentage of economic activity, their exclusion in formal policy skews intended outcomes. Policies intended to promote the advancement of the poor often do not reach them. A modern market economy cannot be concievably achieved without including a majority of the nation's economic activity. Developing nations with large informal economies employ an inverted economic model where only a minority of economic activity is considered.³⁶

A second detriment to the state is revenue deprivation from persecuting informal activities and lost taxes that informals avoid. The state cannot fund sufficient public services

³⁵ De Soto 1992.

³⁶ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

because the deficiency of funds. Informals stand the most to benefit from increased services, and their absence perpetuates the poverty cycle.

In conclusion, without property rights there is no way to effectively organize inputs, distribute risks, share responsibilities, or conduct long term activities.³⁷ Enterprises are prevented from efficiently allocating resources, maximizing economy of scale, and accessing markets. The insecurity produced from a lack of property rights reduces informal capital accumulation, investment, potential productivity, potential output, and profitability.

Political Costs

Even though the informal economy is concerned with economic transactions, it has a pronounced political impact as well. The most glaring issue is the diminished state of rule of law and good governance caused by corruption, and more particularly, bribes. Corruption of state officials undermines the principle of authority and makes it difficult for the state to maintain a legitimate role as law enforcer. The state and informal economy develop a relationship of “inevitable conflict” in which actors in the informal economy try to avert the state or co-opt it through bribes and incentives. Consequently, informals are socialized to fear the government and perceive it as their enemy. They challenge the state’s monopoly of authority.³⁸ As previously described, formal actors bear costs to attain their formal status that informals evade. Extra costs are imposed on those who obey the law, and therefore provide incentives to reject or ignore laws that are not convenient.

The government uses legislation to guide the nation’s financial activity instead of relying on market solutions and economic principles, thereby politicizing the process. This policy pits

³⁷ De Soto 1992, 169.

³⁸ Alejandro Portes and Miguel Angel Centeno, *The Informal Economy in the Shadow of the State. Out of the Shadows: The Informal Economy and Political Movements in Latin America*. Feb. 2003, Princeton University.

different interests against each other in competition for government determined privileges. By allowing the state to pick the winners instead of productivity and profitability, citizens lose equality before the law.

Perhaps the most important consequence is that terrorism and extremist solutions become more attractive in the absence of viable government solutions to poverty and the informal economy. Terrorist organizations like Sendero Luminoso, the FARC, the Taliban, and the Zapatistas all emerge from situations where the government is unresponsive to the basic needs of the population. Alternative and, more often than not, extremist actors intervene when the state does not.³⁹

Social Costs

The exploitation in the informal economy is mirrored in societal relations. Gender discrimination is certainly more intensified as a result of the existence of a large, informal economy. A higher percentage of men are employed in formal enterprises and a greater number of women work informal jobs. Because the different economies also correspond to differentiations in terms of wages, there is a stronger incidence of poverty among women.⁴⁰ This discrimination persists within the informal economy because “women are under-represented in the high-income employment categories (notably, as employers), and over-represented in the low-income categories (for example, as home workers).”⁴¹ Although there is a wage gap between male and female employees in the formal economy, this gap between the sexes is exacerbated in the informal economy. Female informal employees suffer double discrimination;

³⁹ De Soto 1992.

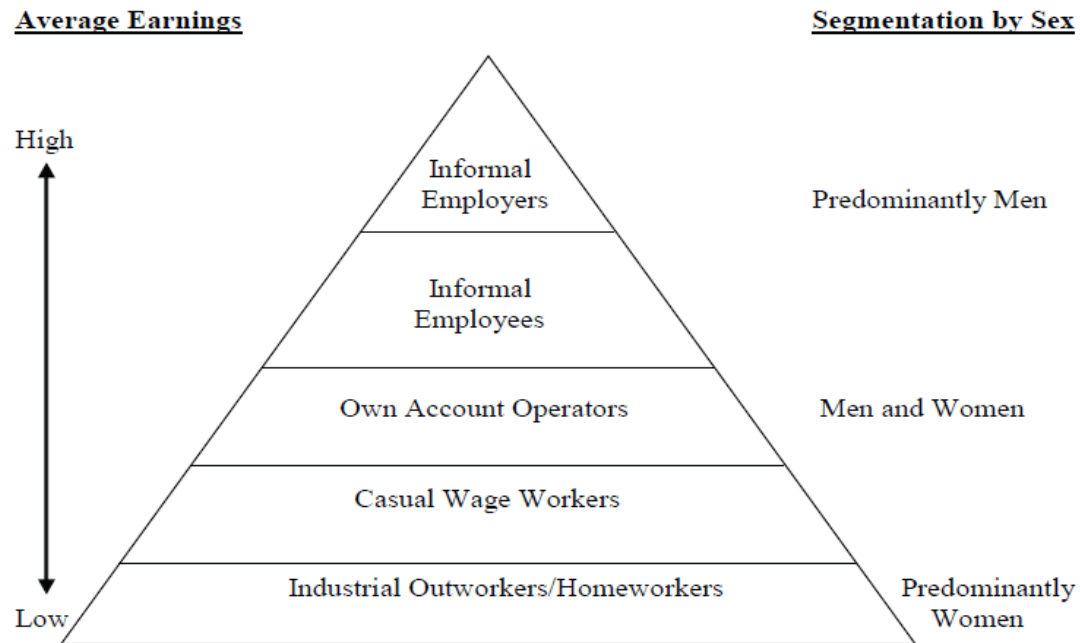
⁴⁰ Ibid.

⁴¹ Reema Nanavaty, *From Local to Global and Informal to Formal*. Expert Group on Development Issues, 2005. http://www.wider.unu.edu/publications/working-papers/discussion-papers/2005/en_GB/dp2005-02/.

they receive inferior wages to the formal economy as a whole because they are informal, and lower wages than men in the informal economy because of their condition as women.⁴²

Figure1.

Segmentation of the informal economy



Note: The informal economy may also be segmented by race, ethnicity, caste, or religion.

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In addition to wage disparity, women in the informal economy are subject to increased incidence of sexual harassment. The insecurity of informal employment makes them more vulnerable to advances from their bosses. Women lack sufficient tools to persecute sexual offenders because of their condition of informality.⁴⁴

Lastly, a much higher percentage of women informal employees work from their homes than their male counterparts. Women are less likely to be recognized as legitimate employees

⁴² Chen, 25.

⁴³ Ibid.

⁴⁴ Ibid.

because they are made invisible in their homes.⁴⁵ Females are also more likely to become socially isolated because homebased work hampers their ability to form social ties outside of their family.⁴⁶ Homebased work is one of the least stable and lowest paying forms of formal employment.

Informal employees are more likely to be exposed to work related sickness and injury. They face the same general risks as formals, such as sickness, disability, property loss, and old age, but have heightened exposure to them because informal living conditions and work environments are not regulated by health and safety codes. "...Exposure to toxic chemicals, repetitive strain and muscular-skeletal injuries, poor sanitation, excessive working hours, and structurally unsafe workplaces" are more prevalent in informal employment.⁴⁷ Frequently an unsafe work environment also connotes an unsafe home environment because many informals work from their homes. Unsafe conditions have a multiplier effect because family members and neighbors are also exposed to poor conditions.⁴⁸

Accidents are particularly devastating to informal actors. Because they have no proof of ownership of their property, they cannot purchase protective measures, such as insurance. They must personally assume all risk for any damage to their property without compensation or access to a social safety net.⁴⁹ Additionally, there is no compensation for illness or work related accidents, which puts informals and their families at risk to lose their homes and principal sources of income.

⁴⁵ Ibid, 12.

⁴⁶ Ibid.

⁴⁷ Ibid, 17.

⁴⁸ *Decent Work and the Informal Economy*, 67-68.

⁴⁹ De Soto 1992, 170.

Human rights abuses are particularly rampant in informal environments. Informal justice systems employ beatings, forced nudity, torture, execution, and expulsion from the community as penalties.⁵⁰ Informal working conditions are not subject to official scrutiny and can be inhumane. Furthermore, child labor is almost completely limited to the informal economy.⁵¹

The concept of equality of all citizens is challenged by the existence of an informal economy. Discrimination based on economic differences is institutionalized. Citizens with more money can afford the protection of the law, while the poor are forced to work outside of state protection. Two different systems of laws and standards are applied to citizens of the same nation.

Lastly, society becomes more violent. Violence is the only coercive method informals possess because of an absence of peaceful enforcement mechanisms, such as contracts and access to police and arbitration. Consequently, violence becomes more prevalent and accepted throughout society.

Desirability of Formalization

Fundamentally, “the informal sector is in fact a euphemism for cheap labor employment... It denotes a system of very intensive exploitive labor with very low wages and often long hours.”⁵² Additionally it stunts growth and development potential. On a macroeconomic level, the informal economy cannot grow independently of the formal. It results from formal stagnation, not because of indigenous opportunities for growth. Therefore, it can be considered as a survival strategy rather than a development strategy. NGOs have proposed various innovative solutions and pilot programs to circumvent the problems of informality, but

⁵⁰ Ibid.

⁵¹ *Decent Work and the Informal Economy*, 42.

⁵² C.K. Omari, *Rural Women, Informal Sector, and Household Economy in Tanzania*. Working paper no. 79. World Institute for Development Economics Research, Mar. 1989.

none of these resolutions are sustainable in the long run. Participation in the formal economy is incontestably preferable for employers, entrepreneurs, and the state. The question is not whether or not formalization is desirable, but how to make formal participation accessible.

Role for Government Intervention

The government has a responsibility to ensure equality and promote well-being for all citizens. In order to do this, it must foster a robust and healthy economy. These duties give the government a definite role to intervene on behalf of formalization efforts. The government already intervenes in the economy in the form of legislation that creates barriers and excessive entry costs to access legal activity. In many cases it also provides large subsidies to certain industries and large businesses that benefit only a small portion of the population. This is certainly not the most equitable or efficient use of government money.⁵³ In fact, these actions indicate that governments in countries with large informal economies are discriminating against their own low-income citizens. It is imperative that the government redirects its participation in the economy by creating inclusionary policies and avenues to formalization to correct for its current discriminatory behavior.

⁵³ Alter Chen, 18.

Part Two

Appropriateness of the Legalist Approach?

Undoubtedly, high costs and entry barriers of the informal economy make formalization a desirable choice. The success of the ILD's program in Peru has garnered worldwide attention and several governments have expressed an interest in participating in similar reforms. In fact, the ILD has already worked with the governments of Haiti, Mexico, Honduras, Albania, and the Philippines over the past ten years.

Again, the legalist approach to formalization has a distinct link to Peruvian culture because the Peruvian context formed the basis for the ideas proposed by de Soto and his colleagues. As evidenced by the global nature of their work, de Soto and the ILD feel that the legalist approach to formalization can be universally applied. While they acknowledge that each country context requires a nuanced approach to diagnose and treat its particular problems, the overarching concepts of granting property rights and simplifying bureaucracy are applicable in all developing nations with large informal economies.

Despite this assertion, some scholars feel that the legalist approach functions best in a Peruvian, Latin American, or Western context. They conclude that in Asian, African, Middle Eastern, or other cultures, this paradigm fails to yield the same results because the native culture is not compatible with a modern market economy. Some scholars propose that societies have large informal economies because their cultures develop in such a way that the informal economy is a natural manifestation, and thus, their people actively shy away from the form economy. But perhaps the most largely cited discordance is the insistence that indigenous institutions are not compatible with a modern market economy. Believers of this school of reasoning claim that either culture must be changed in order to achieve development through

modern market activities or that these cultural groups will continue their own brand of economics regardless of whether they attain improved living standards. Rao and Walton sum up this argument saying that

‘culture’ matters because societies steeped in traditional cultures are unsuited to market oriented development and are thus fundamentally hampered in their pursuit of growth. ... the challenge for development then is to reform culture by inculcating more growth –and mobility oriented perspectives- through education or other means of transforming ‘toxic cultures.’ Culture here is the enemy- a voice from the past that inhibits societies from functioning in the modern world.⁵⁴

In March 2005, the Commission for Africa similarly concluded that Africa in particular has the “wrong kind of culture” for development because of the prevalence of “regressive tribal structures.”⁵⁵ The Middle East and North Africa are frequently accused possessing cultures that are incompatible with a modern market economy because of the particular restrictions that the Islamic religion and Muslim culture place on their economic dealings and social relations.

Doubts about the ability to transform the informal economy into a formal economy that stimulates growth and fosters sustainable development must be examined in order to generate effective development policies. To test the universality of the legalist approach, Tanzania and Egypt, two countries with cultures different from the Latin American, Catholic, and heavily western influenced culture of Peru, have been chosen as case studies. Egypt represents a Middle Eastern and Muslim nation and Tanzania an African nation with religious beliefs split almost equally between Christian, Islamic, and indigenous religions. These countries are particularly relevant because their leaders, Presidents Mubarak and Mkapa respectively, have called upon the help of the ILD to create formalization programs in their countries. Therefore, the assumption of universality needs to be correct in order for these programs to be effective.

⁵⁴ Vijayendra Rao and Michael Walton. *Culture and Public Action*. Stanford: Stanford UP, 2004, 10.

⁵⁵ Joy M. Moncrieffe, *The Role of Culture in Development*. Commission on Africa, March 2004.
http://www.commissionforafrica.org/english/report/background/moncrieffe_background.pdf.

Case Studies Background

Tanzania

The best available estimates of Tanzania's informal economy show that over 90% of economic activity takes place in the informal economy, where over \$29 billion in extralegal assets are held.⁵⁶ An incredible 98% of the total number of businesses operate extralegally, corresponding to 1.5 million enterprises. Additionally, 89% of all property is held without titles, the equivalent of almost 1.5 million urban properties and over 62 million hectares of rural property combined.⁵⁷

Tanzania does have a system set up to legally register and title property based upon German and British principles inherited from colonial times.⁵⁸ This system theoretically contains all of the policies and laws necessary to run a modern market economy. However, the large degree of informality indicates that the majority of citizens lack access to this system, which generates the same high costs and entry barriers that plague Peru. The cost of a program to allocate urban land to an enterprise and legally register a business permit requires 8 years to complete the 68 bureaucratic steps and costs \$2,262.⁵⁹ In order to legally incorporate a company, one must pay \$5,506 and spend 379 days to complete the 103 stages in the registration process.⁶⁰ And in order to access a court in order with the purpose of resolving a commercial dispute, entrepreneurs must go through 96 steps that take about 390 days to complete and cost \$11,964.⁶¹ A complex network of over 100 administrative offices which are involved in the most common

⁵⁶ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

⁵⁷ Ibid.

⁵⁸ Gier Sundet, *The formalisation process in Tanzania: Is it empowering the poor?* Norwegian Embassy in Tanzania, Dec. 2006. http://www.statkart.no/Engelsk/Cadaster_and_Land_Registry/Property_Centre/Hidden/News/filestore/Eiendomsdivisjonen/PropertyCentre/Pdf/theformalisationprocessintanzania_301008.pdf.

⁵⁹ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

⁶⁰ Ibid.

⁶¹ Ibid.

business and property transactions further complicates the formalization process.⁶² Equal to the Peruvian situation, formalization procedures and access to the benefits of the formal system, such as courts, require exorbitant quantities of time and money to access them. However, in contrast to the highly centralized system of Peru, Tanzanian assets are held in dispersed local arrangements that are difficult to bring together in a meaningful way on the national level.⁶³

Egypt

Analogous to the enormous size of the informal economy in Peru and Tanzania, Egypt holds approximately \$248 billion of assets extralegally.⁶⁴ The magnitude of this number is 30 times greater than the market value of all the companies registered in the Cairo Stock exchange and 55 times greater than the value of all direct foreign investment in Egypt up to 1996.⁶⁵ Therefore, it is hardly surprising that 92% of real estate assets are held outside the formal system and 82% of businesses operate extralegally.⁶⁶

Again, Egypt exemplifies a case of a country with a large informal economy despite the fact that it has infrastructure for titling land and registering businesses. Once again this system is inaccessible to the majority of the Egyptian population because of the high costs and entry barriers it poses. For example, it takes 549 days to complete the 15 legal processes and visit the 26 institutions needed to open a bakery. Additionally, it costs a figure equal to 26 times the monthly living salary to complete this process and an equal amount each year to comply with the fees to keep it legal.⁶⁷ Registering a property is equally difficult: in order to purchase state owned

⁶² Ibid.

⁶³ Ibid.

⁶⁴ "Dead Capital in Egypt," Instituto Libertad y Democracia. http://ild.org.pe/sites/default/files/diagnosticos/egypt_en.pdf.

⁶⁵ Ibid.

⁶⁶ Ibid.

⁶⁷ Ibid.

land and register a dwelling on it, one must go to 31 public and private offices and spend between 6 and 14 years to comply with 77 bureaucratic procedures.⁶⁸

Egypt's informal economy also struggles to keep up with rapid urbanization occurring throughout the country, and especially in the capital, Cairo. The majority of services in cities are provided informally. However, with a steadily increasing population, it has become increasingly difficult to coordinate the thousands of agreements between informal service providers and those they serve.⁶⁹ Service providers are unable to take advantage of the potentially the most important tool in organizing their economic transactions, technology, because of their condition of informality.

Extralegal Law System

Formal law is often erroneously used as a synonym for the Western law system. The Western legal system was the first to create a codified way to represent property and regulate business through bureaucracy. Consequently, it has become the model that other nations have followed in order to achieve entrance to the modern market economy. Scholars are in fact correct in their assessment that exporting the Western legal system to developing nations with large informal economies is a futile and fruitless endeavor. What policy makers in these nations fail to recognize is that the Western way is neither the only nor necessarily the best way. They need to find ways to represent the same concepts that the Western system achieves, but it does not have to be an exact replication. The common man in these countries is not accustomed to the Western system(s) and does not understand it. Consequently the Western system is not a legitimate approach to creating a successful formal system when transplanted to other cultures. Instead, successful development of a formal economy is contingent upon applying common principles,

⁶⁸ Hernando de Soto, *Dead Capital and the Poor in Egypt*. Egyptian Center for Economic Studies, 1997.
http://www.eces.org.eg/Uploaded_Files/65629E93-107C-47CA-9DE7-2B0660564ACC_ECESDLS11e.pdf.

⁶⁹ De Soto 1997.

such as a way to represent property, in a many that draws upon the social environment and historical experiences of the country and in question. Informal entrepreneurs already have created their own indigenous institutions that mimic the function of legal structures in the formal economy, but in a way that greatly reduces cost and entry barriers. This makes the system more viable for inclusion of all citizens. This system, referred to as “extralegal law,” is the set of mutually agreed upon norms and rules that govern the transactions in the informal economy. Although they are not officially enforceable, community acceptance of the rules creates a kind of social pressure that ensures widespread compliance.

The existence of an extralegal law system proves that the concept of the formal economy itself is not culturally alienating because informals spontaneously create systems that essentially carry out the same functions that the formal economy does. By creating their own parallel systems, informals demonstrate an understating of the need for an economy governed by defined rules and regulations. The only difference between their improvised extralegal system and the formal system is that the former intends to realize the same functions of organizing citizen’s lives and carrying out economic transactions in a way that is more widely accessible and culturally befitting. While Western inspired laws fail to properly function in the majority of outside cultures, indigenous interpretations and representations of law through self-created extralegal systems are more culturally legitimate.⁷⁰ Moreover, extralegal laws are certainly closer related to a modern market economy than feudal, communist, or tribal systems.⁷¹ They are based on rational thought and actualized through modern means, such as village meetings and administrative acts, rather than tradition, violence, or other cultural aspects.⁷² Therefore, the

⁷⁰ De Soto 1992, 19.

⁷¹ Ibid, xvii.

⁷² *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

informal economy is not a rejection of the formality, but instead demonstrates that informals scorn the arduous process of achieving it.

In fact, the evolution of extralegal processes was an important step in constructing today's developed modern economies. All of the current modern industrialized nations had expansive systems of indigenously generated extralegal practices originated to meet needs that were not fulfilled by the formal law systems of the time. These practices became the basis for modern formal law when "governments wrote out, codified, and gave articulated form to extralegal processes."⁷³ Therefore, not only does the extralegal law system prove that the informal economy is not culturally incompatible with formal law, it can (and should) form the basis for formal law.

Extralegal Law in Context

Peru

The extralegal law system was first explored in detail in Peru by de Soto and the ILD during the 1980s. They discovered that in lieu of formal regulation, informals created a set of extralegal norms to govern social and economic relations. These informal laws were compiled from an amalgamation of customary law and rules borrowed from the official legal system.⁷⁴

An invasion contract and the expectative property right present two clear examples of informals using grassroots measures that intend to produce results roughly similar to those of the formal system. The invasion contract is the source of system of extralegal norms that govern informal settlements, much like a constitution or community charter.⁷⁵ It is much more flexible than official law in responding to the needs of the populace, and therefore is a more workable option. Unlike formal law, the Contract is open to the inclusion of new parties without the

⁷³ De Soto 1992, xvii.

⁷⁴ Ibid, 19.

⁷⁵ Ibid, 22.

associated entrance barriers and costs. Another difference is that it is continuously updated to respond to current circumstances through the free consent of interested parties.⁷⁶ The expectative property right is essentially a property right to informally held land.⁷⁷ Informal property holders use it to differentiate their property from their neighbors and to lay claim over their land. However, there is no legal equivalent to this right and it is difficult to enforce, especially to authorities. Therefore, this “property right” is only recognized and most utile among informals themselves.

Informal organizations are an additional component of the extralegal system in Peru. Leaders of communities or certain occupations (akin to trade unions) are elected to represent the informal community. By defining norms and rules, mediating disputes, and penalizing crimes, they act much in the same way that formal authorities operate.⁷⁸ For example, informal housing organizations carry out the same functions as a municipal government: they aim to protect and increase the value of property, negotiate with authorities, preserve law and order in the community, secure the provision of services, register settlement properties in the community register, and administer justice.⁷⁹

Tanzania

Tanzania is home to a complex and well-developed system of extralegal relations based on the local interactions of thousands of Tanzanians.⁸⁰ The ILD has identified an informal economic model with 17 underpinning archetypes, which they define as “patterns of social interaction whose further development is fundamental to the creation of a legal economic order

⁷⁶ Ibid, 23.

⁷⁷ Ibid.

⁷⁸ Ibid, 26-27.

⁷⁹ Ibid, 27.

⁸⁰ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

that is rooted in Tanzania's indigenous culture.”⁸¹ Essentially, these archetypes are expressions of informal laws that allow for the organization and governing of daily activities, especially economic transactions. They create an abstract order on how to conduct economic and social interactions, even though they are prohibited from superseding the local level.⁸² The Tanzanian extralegal system organizes and regulates dealings that involve property, business organizations, and an expanded market much the same way the formal system does.

Analogous to the formal system, the structure of these relationships are physically represented by documents. This characteristic is important because documents allow for the existence of property rights and other legal tools that create advanced market economies. They assist in “creating property, extracting credit and liquidity from physical assets, and structuring entrepreneurial associations where they can divide labor internally and trade externally” which allows informal entrepreneurs “to make economic decisions, cooperate with each other, structure their collaboration, resolve problems, and protect their values.”⁸³ Even without formal or legal training and burdened by a limited infrastructure, Tanzanians produce a very professional degree of document creation. They designate drafters to write the documents, elect authorities to stamp and authorize them, employ facilitators to fill them out, have electors to revise them, use *mwenyekitis*⁸⁴ to file them, have citizens to realize their actions, and utilize adjudicators to declare them active or invalid.⁸⁵ To facilitate property transactions, the ILD identified documents with the specific objectives of adjudication, documentation, registration, fungibility, collateral, and testament.⁸⁶ In terms of business organization, documents to create association, division of

⁸¹ Ibid.

⁸² Ibid.

⁸³ Ibid.

⁸⁴ A chairperson of the Kwaya ethnic group

⁸⁵ Ibid.

⁸⁶ Ibid.

labor, management structure, transparency, and traceable liability are used.⁸⁷ Finally, identification, redundancy, attestation, representation, standardization, and contract documents exist to fulfill the needs of accessing an expanded market.⁸⁸ Although not formally recognized, the community agrees to respect these documents and the decisions of elders as law. These informal legal manifestations deliver, as best they can, the same utility and guarantees as the formal system does. Additionally, the spontaneous use of documentation demonstrates that Tanzanians value “written representations where people, assets, values, and memory can be organized with fecundity to produce a surplus value.”⁸⁹ Again, by mimicking the functions of the formal economy down to creating documentation, Tanzanians demonstrate that they are not culturally opposed to any kind of formal system nor do they have difficulty understanding the concepts and tools needed to coordinate a modern market economy.

Lastly, in small or tribal societies, documents are unnecessary because of connections through kinship and easy recognition of those with who you are in close contact. The documentation system proves that Tanzanians are not content to work solely in a limited, local context and would like to reach out to an expanded market. They do not wish to be prevented from working in a national or global context because of cultural limitations. Informal documentation is one way that Tanzanians articulate their desire to interact in a modern market economy.

Egypt

The extralegal system in Egypt is more difficult to study because of the lack of ethnographic studies on the actual structure of its activities and institutions. Additionally, the

⁸⁷ Ibid.

⁸⁸ Ibid.

⁸⁹ Ibid.

ILD, which has conducted the most in depth studies of this economy, has not responded to inquiries for information. Despite this, there are clear examples of extralegal norms that aspire to regulate interactions the same way the formal system does. Institutions that parallel formal “market institutions, enforced by social pressure, custom, and share societal imagination” are widespread in Egyptian informal society.⁹⁰

Perhaps one of the most prominent expressions of the extralegal system is the informal banking system. A lack of formal documentation, property rights, and guarantees puts the banking system out of reach for the majority of Egyptians. Consequently, many alternative informal institutions were created to fill their void. Initially informal banking was carried out by so-called Islamic companies until the 1980s when Law 146 forced these enterprises into reform or bankruptcy.⁹¹ Not only would these companies hold deposit reserves, they would carry out investment activities and provide loans. At one point the Islamic investment companies could brag of possessing over 254,000 investors.⁹² When the Islamic banks disbanded, new forms of informal banking took their place. One such alternative is the informal banking system managed by groups of informal women. It has the additional feature of dealing in currency exchange.⁹³ A third alternative to the formal banking system is the informal credit system known as *gamaiyyat*.⁹⁴

Trash collecting is a key service provided by the informal economy in Cairo and other major Egyptian cities. The trash collectors have established a grassroots system of rights and obligations to regulate their activity. Modeled after licensing and property rights, the collectors

⁹⁰ Frost, 16.

⁹¹ Julia Elyachar, *Mappings of Power: The State, NGOs, and International Organizations in the Informal Economy of Cairo*. New York University, 2003.

http://journals.cambridge.org/download.php?file=%2FCSS%2FCSS45_03%2FS0010417503000264a.pdf&code=c5dbef6cb1a4b09cad870197ef071dd8, 577.

⁹² Ibid.

⁹³ De Soto 1997, 44.

⁹⁴ Asef Bayat, "Cairo's Poor: Dilemmas of Survival and Solidarity." *Middle East Report* 2002 (1996): 2-12.

acquire specific “rights” as the sole people who can carry out the activity and additionally create “contracts” that give them exclusive claim to collect from certain building or apartment sites.⁹⁵

There are penalties for those that infringe on collecting territory that is not their own.

Comparable to formal property rights, the collection routes of trash transporters can be sold or inherited. An important distinction exists between the *wahiya*, those who collect trash from the site and the *zabbaleen*, those that transport and dispose of it. Many informal mechanisms are in place in order to enforce this division. Some reflect formal methods, such as arbitration, and others, such as violence and vandalism, exemplify the hazards of informality.⁹⁶

Similar to Peru, neighborhood associations act as local authorities in Egypt.

Neighborhood meetings are conduits that ensure the flow of information about community rules. Local leaders are considered the highest authority in this informal governance system. Perhaps their most important role is providing an alternative to the formal justice system by acting as a mediator between informal peoples and the government or private sector, and for disputes between informal vendors.⁹⁷

A variety of a social safety net is also a characteristic of the Egyptian informal economy. Despite the “...absence of legal regulation, informal labor market ‘arrangements’ for sick leave, vacation, recruitment, promotion and pay persist in these sectors in semi-standardized forms.”⁹⁸ For instance, when a worker is sick and cannot work, they are not entitled to pay. However, they can take out credit that can later be deducted from future pay so that the work time lost is not financially damaging.⁹⁹

Shortcomings of the System

⁹⁵ Ragui Assaad and Lili Buj, “La transformación del sistema de recolección de basura de El Cairo.” *Revista Mexicana de Sociología* 57.1 (1995): 178.

⁹⁶ *ibid.*, 179.

⁹⁷ Bayat.

⁹⁸ Frost, 17.

⁹⁹ *Ibid.*

Even the most advanced extralegal law systems are no substitute for a formal legal system because of the lack of guarantees and “enforceable law that allows each enterprise to function unwaveringly under one point of control.”¹⁰⁰ Informal laws may be recognized in a local context, but it is impossible to create national or global economic relationships until economic relationships are governed by widely recognized and enforceable rules. Without them, it is impossible to provide the guarantees needed to create security in economic transactions. For example, the expectative property right is useful in organizing a community, but it does not offer the complete security of a legal property right. The insecurity of informal property rights also deters adequate investment, as demonstrated in the aforementioned example of the Peruvian informal neighborhoods of Mariscal Castilla and Daniel Alcides Carrion. In economies like Tanzania, documents are not coordinated in any organized manner, resulting in entrepreneurs and citizens that are trapped in fragmented and undeveloped conditions.¹⁰¹ Furthermore, informal arrangements lack complete legitimacy because citizens are more accountable to local political and social context, which often carries a bias, rather than benefiting from the impersonal application of formal law.¹⁰² Even though informal laws may create somewhat more secure relationships, economic information is still difficult to collect because information is not stored in a fixed place. If an informal registry or other information collection mechanisms exist, they could be retained in three separate and uncoordinated registration systems (local, regional, and national).¹⁰³ Moreover, most of these rights take time to establish, while formal documents instantly create a reliable relationship. Therefore, while the informal extralegal system does aid in organizing economic relationships, it is not sufficient to replace a formal system.

Mobility

¹⁰⁰ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

¹⁰¹ *Ibid.*

¹⁰² *Ibid.*

¹⁰³ *Ibid.*

Mobility between employment in the formal and informal economies serves as further proof that developing countries are not culturally opposed to a formal economy. In Peru, Egypt, and Tanzania there is fluidity in the movement of employees between the two economies, implying that there are not two separate workforces. It is often the case that full time employees of the formal economy will supplement their income with flexible, informal tasks. For example, in 1984, a typical Tanzanian family of 6 could only feed itself for 4-6 days a month with the wages earned in the formal economy.¹⁰⁴ Members of that family would have to turn to supplemental employment in the informal economy in order to meet their basic needs. In other circumstances it is common to switch between full time employment in the formal and informal economies. This would occur when one economy experienced a shortage of jobs or wages were insufficient. The lack of separation between the workforce of the two economies and fluid movements between them demonstrate that employees in developing nations are in fact basing their employment decisions on a rational evaluation of where they can most benefit rather than on cultural preferences. If informal workers were truly culturally opposed to a formal economy, they would remain employed solely in the informal economy and have no dealings with the formal.

Conclusion

Scholars are partially correct in their assessment that social, cultural, and ethnic preferences, skills, and patterns of behavior do affect the economic situation of a country. However, the role they play is in determining how the informally economy manifests (i.e. the activities that take place and how citizens understand their economy) and cannot be attributed as the reason for why it exists. Culture and history influence the way that different peoples adapt to markets, but this does not indicate that they are incapable of participating in a modern market

¹⁰⁴ Tripp, 9.

economy. Cultures have unique interpretations and expressions of the same concepts. This is best demonstrated by indigenous extralegal systems. Through these systems, people from all cultures have developed their own ways of representing property and regulating economic transactions in a more effective manner than when they simply imitate the Western legal tradition. Culture is an important element not in determining if certain groups are capable of participating in a modern economy but rather in how they create their own mechanisms of expression that best reflect the society's comprehension of modern economic tools.

Unfortunately, most developing nations borrow the Western system as their own because they admire the economic success of today's modern industrialized nations. In these nations, the Western system creates restrictions in the form of high entry barriers and costs instead of meeting the needs of the people. Spontaneously generated extralegal systems have spawned in order to best facilitate economic transactions in societies where most people do not have access to the formal system because it does not adequately suit their needs. However, these extralegal systems prove that people are not turning to the informal economy because of cultural preferences. They demonstrate that all people understand the need for rules to govern their economic transactions. Furthermore, the fluidity of mobility between employment in the formal and informal economies indicates that employees are not directly opposed to the formal economy. If this were the case, employees would reject the formal economy completely and only work in the informal economy.

The only reasonable conclusion is that the majority of people are restricted to participation in the informal economy because the regulations of the formal economy do not permit them to easily carry out all the functions necessary to realize daily economic transactions. In each case mentioned, individual concerns appear which are particular to the country studied.

For example, Egypt struggles with increased urbanization and Tanzania has difficulty connecting its local and national economic transactions. Despite this, there are common circumstances characteristic to all three informal economies mentioned: high costs and entry barriers. Ergo, the differences of individual cultures do not prevent nations from enjoying the benefits of a formal economy. It is the common problem of employing maladapted Western economic models instead of utilizing culturally relevant systems of understanding the same economic concepts that prevents successful economic integration.

Policy Suggestions

This paper will conclude with some policy suggestions on how to transform the current economic regimes of developing countries in order to best take advantage of a formal economic system. The challenge to do this “is two-fold; to tailor existing legal institutions to suit the poor, a top down exercise, and, then, to harmonize, professionalize, and formalize the extralegal archetypes of the poor, a bottom up exercise, so that the government...can eventually have its two institutional realities meet somewhere in the middle.”¹⁰⁵

To reiterate, it must be stressed that even though the general approach to formalization is universal, a homogenous blanket policy is not advocated. The existence of virtually all informal economies arises, at least in part, from a lack of property rights and excessive bureaucracy. However, the specific ways they foment problems are case specific and need to be understood in their own unique context in order to properly treat them. Policies should examine the particular circumstances in each country to determine in what ways laws are failing and how they create high costs and entry barriers. Not all aspects of the legalist’s comprehensive reform program should be employed in all contexts, nor will all expected results be achieved in every case. The

¹⁰⁵ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

legalists themselves propose a nuanced solution based on a foundation of property rights and simplified bureaucracy.

“Legalist Prescription”

De Soto and the ILD have created their own “prescription” on how to best carry out formalization reform. Their recommendations are largely based only simplifying laws and strengthening legal institutions, which reduces the costs of productivity without altering the functions of the legal system.¹⁰⁶ The process of debureaucratization and deregulation involves “increasing the responsibilities and opportunities of private individuals and reducing those of the state.”¹⁰⁷ To carry out the process, unnecessary, contradictory, and inconsistent laws must be redesigned or eliminated. Moreover, laws that are still relevant must be updated to confront current challenges. Simplification also includes clearly defining the legal institutions and processes involved in formalization to avoid confusion and redundancy. Finally, the process of formalization needs to become more accessible to the common people. For example, in many cases documents needed for registration are not written in the native language of the people, but in the administrative language usually determined by formal colonial powers. In Tanzania, almost all legal documents are written in English, even though the majority of people speak Swahili.¹⁰⁸ Documents need to be obtainable in all major languages spoken in a nation. It is also critical to ensure that the language of procedures and documents are clear to common people with little or no legal or formal education. Instructions should be written in plain language and not legalese.

¹⁰⁶ De Soto 1992, 247-253.

¹⁰⁷ Ibid, 248.

¹⁰⁸ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

The majority of developing nations have been colonized by Western industrialized powers at some point in their history. This has created a situation in which lawmakers are

obsessively concerned with bureaucratic paperwork and details of authenticity and verification. Well within colonial traditions... [Even long after independence] jurists have been taught to create law through the exegetic adaption of foreign texts. What is missing are techniques that involve citizens: participation, accountability, transparency, or grassroots practices.¹⁰⁹

Economies can only be effective when they are based around the reality of the people and not documents.¹¹⁰ The best way to tap into grassroots practices is to reform laws in such a manner that they reflect how informals conduct business in the extralegal system. Informals choose to follow the laws they create instead of formal ones because their own are the ones that work best in practice. Furthermore, common people already respect, understand, and follow these norms.¹¹¹ The best way to represent the concepts and practices necessary for participation in a successful modern market economy already exists in the form of current extralegal practices. They should create the foundation for the formal legal system. In all programs created by the ILD, the newly created legal devices are consistent with the principles that the poor created in their own legal systems.¹¹²

Beyond Legal Reform

Reforming laws and bureaucracy is only the foundation for reform. Comprehensive reform is more complex "...because the root causes of the informal economy are multifaceted, legalization alone is not enough to promote decent work."¹¹³ The complete reform package must include a

¹⁰⁹ De Soto 1997, 24.

¹¹⁰ De Soto 1992.

¹¹¹ Ibid, xxix.

¹¹² Ibid, xxv.

¹¹³ *Decent Work and the Informal Economy*, 6.

Strong and effective judicial, political, economic, and other market and non-market institutions and equitable access to these institutions is essential. Informal workers and enterprises also need access to resources, information, markets, technology, public infrastructure, and social services; they need a “leveling playing field” [which includes] similar rights, facilities, and access.¹¹⁴

Any reform program must encompass reforms that not only help informal entrepreneurs to gain access to the formal system, but must also include tools to help them fully take advantage of the opportunities of the system.

Governmental Reform

Depolitization of the law making process is critical in maintaining the sustainability of formalization reform. In most cases, laws are conceived so that certain interested groups benefit from them. These groups, which can include the government as well as private actors, usually have the strongest political power and use their power relations to ensure that they gain privileges from the law. Important political actors are hesitant to initiate any kind of reform program that would cause them to lose control over the economy because of their desire to maintain their privileges. For example, the government of Tanzania rejected a proposed property formalization program in 1990 on the grounds that

The President, as Head of State, is responsible for the development of the country and well-being of the people, and land being an important element for development has to be controlled by the President. If land is vested in [the] Board of Land Commissioners and the Village Assemblies, then the government will be turned into a beggar for land when required for development... The Government will not implement policies in that way. The Investment Promotion Policy will be impossible to implement when the Government does not have a say in land matters. Land has to remain in the hands of the Government.¹¹⁵

Even though the rejection of formalization is wrapped in the rhetoric of development, it is clear that the government is simply adverse to losing control over such a precious commodity.

Depolitization will perhaps be the most difficult aspect of the reform process to achieve the

¹¹⁴ Ibid.

¹¹⁵ URT 1993a:5 as cited in Sundet, 9.

extent of corruption and desire for control by political elites provides no incentive for them to renounce their control. Nonetheless, it is essential that the economy be run on market principles rather than government direction if it is to develop sustainably and include all actors.

In addition to depolitization of the economy, stability needs to be encouraged through rule of law. Laws need to be respected by the government as well as by the people. This means that the government cannot overturn transactions that are legal because they do not benefit leaders. The common people have no mechanisms to defend against the “excessive and unregulated discretionary powers over applying laws and regulations” of the authorities.¹¹⁶ Once again, a situation occurs where power relations rather than efficiency determine the winners and losers in the economy, with the losers generally being the mass of poor citizens.

A long term method to tackle this issue is the promotion of democracy and good governance. Overall representation of informal peoples needs to be improved because “people in informal work represent the largest concentration of needs without a voice, the silent majority of the world economy.”¹¹⁷ Without representation, the poor lose their share of political power and are left with little leverage to counteract the existing power structure. Lawmaking bodies need to be open to receive and process user feedback so that they can incorporate the experiences of the poor into the lawmaking process with the end goal of producing non-discriminatory laws.¹¹⁸ A concrete measure to achieve this is the creation of an ombudsman to represent the people, regardless of socio-economic status, and negotiate solutions to their grievances with the government. This is one of the first reform measures the ILD realized in Peru.¹¹⁹

Judiciary reform is another key governmental reform in the formalization process. A stable and effective judicial system is a central tenet in a functioning market economy because

¹¹⁶ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

¹¹⁷ *Decent Work and the Informal Economy*, 71.

¹¹⁸ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

¹¹⁹ “The ILD Program.”

they are the coercive mechanism to guarantee compliance with agreements. For a formal economy to be advantageous, the judiciary has to be efficacious. For example, the current operation of the judiciary in Peru is not enough to bring about benefits of formalization. 17% of legal businessmen say they won't enter a joint venture because of fear that disagreements will arise and be costly.¹²⁰ The lack of effective compliance mechanisms lowers business productivity and potential expansion. In order to maximize the benefits of formalization, the institutional strength of structures related to the economy, such as the judiciary, must be improved.

Lastly, government needs to work on coordination in order to successfully achieve formalization. Coordination has implications for the multiple levels of government as well as between governmental bodies. It is imperative to strike a balance between federal, regional, and local responsibilities. In order to eliminate bottlenecks, no one governmental level should be responsible for the totality of formalization requirements. In some cases, such as that of Peru and Egypt, this calls for decentralization by transferring legal and administrative responsibilities from the central government to local authorities. However, in cases like that of Tanzania, it is necessary to bridge the extensive amounts of assets controlled and located in local communities and connect them in a national context. This implies a stronger role for the federal government. All levels of government must increase communication in order to coordinate policy and reduce duplications or redundant procedures. Lastly, the sphere of authority of different governmental institutions must be clearly defined so that tasks do not overlap in different bodies.

Roles for Non-Governmental Actors

While the government is the most powerful actor in the formalization process, it is certainly not the only one. Civil society and NGOs have key roles in the reform process from

¹²⁰ Luis Aliaga, *The War of the Notary Publics*. Lima, 2004.

identifying problems to ensuring that reforms continue to be sustainable for in future. Therefore, it is crucial that both of these actors are encouraged to participate in the reform process.

Civil society creates pressure on the government to live up to its reform promises by monitoring the government's activities and publishing information on them. It can act as a mechanism to provide transparency about the difficulties informals face in accessing formalization programs, laws and barriers that prevent access to the formal economy, and spread information to ensure that the formalization process is not manipulated in favor of interests it is not intended to assist. The media is perhaps the most important actor in disseminating information. For example, in Peru the media was effectively used to expose outrageous stories related to excessive bureaucracy. Public response to these stories was so alarming that the government was forced to respond to it.¹²¹

NGOs facilitate the identification of problems with current laws and propose solutions. They are also important in aiding the coordination between different agencies and institutions involved in the reform. The ILD provides a prime example of an organization that carries out these activities. Lastly, NGOs help to fund and manage capacity building programs that assist informals in meeting the demands of the formal market.

Education Campaigns and Increased Access to Formalization Program Services

Formalization programs need to be “pro-poor” in order to achieve intended results. One of the greatest deterrents to formalization is the *perceived* costs and difficulties. Widespread education campaigns are needed to inform the informal workforce and informal property owners about policy changes and new programs. These education initiatives should deliver information

¹²¹ De Soto 1992, xxviii.

on the program's objectives, especially why formalization is beneficial and how to access formalization programs.¹²²

Additionally, the people must be able to physically access the tools needed for formalization. In Tanzania, only 6 registry offices exist nationwide.¹²³ This problem is prevalent in all developing countries and especially affects rural residents. Formalization programs can hardly achieve their expected objectives if the program's instruments are unavailable to the large majority of the population. The number of program offices and knowledgeable staff needs to be increased.

Increase Capacity and Training

It cannot be expected that solely by changing laws, informals will seamlessly adapt to the formal economy. Reform programs need to provide "a range of services...including microfinance, business development, infrastructure, social [programs] (health, education, and childcare), occupational health and safety [measures], and social protection (insurance safety nets, disability, and pensions)." ¹²⁴ Additionally, previously informal entrepreneurs need coaching on how to access credit, technology, markets, training, government services, and market information.¹²⁵ General training should involve how to handle new experiences, such as specific customer demands, accounting methods, and other new aspects of business particular to the formal economy.¹²⁶

It is equally important to the success of formalization programs that their organization scheme and the staff who manage them are competent. Again, there needs to be a defined and easily locatable office at which people can receive information and submit paperwork.

¹²² Garcia-Bolivar, 18.

¹²³ *Program to Formalize the Assets of the Poor in Tanzania and Strengthen Rule of Law: the Diagnosis.*

¹²⁴ Chen, 36.

¹²⁵ De Soto 1992, 107-108.

¹²⁶ Garcia-Bolivar, 18.

Additionally, the program should have a systematic filing scheme so that information is easily locatable and can be shared. Staff need to be aware of the components of the formalization program and trained to aid others in their completion.

Job Creation

One of the largest problems associated with the formal economy is an insufficient number of formal jobs and underemployment. This forces citizens to seek alternative or supplemental employment in the informal economy. In order to promote formalization, there must be employment available in formal positions. While a country may be growing in terms of GDP, this wealth can only spread to help those in the poorest sectors of society if they have jobs that proportion them some part of the growth.

The most jobs in the developing world are created by micro and small enterprises (MSE) and small and medium enterprises (SME). Even though each individual enterprise employs a much smaller percentage of employees than large businesses, put together they create a sizable share of total business activity and overall employ more people. Governments should support policies that encourage MSE and SME creation and development. In order to fund programs that aid these enterprises, governments should cut subsidies to large companies, which distort transactions in a market economy and stagnate growth. Instead, this funding should be reallocated to programs that help MSEs and SMEs to access capital and capacity to help them effectively establish themselves in the formal economy. The option of a government sponsored micro-finance program should be explored as a way to provide small loans to low income individuals and MSEs. This technique has produced encouraging results in a number of developing nations.

Demand Creation

Goods and services need to be demanded for MSEs and SMEs to grow and, in turn, demand more employees themselves. The state can help foment demand by creating a bidding system for government contracts. This policy has the bonus of lowering government expenditure because contracts are competitively offered to the lowest bidder rather than gifted to large companies. Even when government orders are too large for one enterprise to fulfill, MSEs and SMEs can still benefit from the bidding program by creating consortiums that split the work among many companies.¹²⁷ Furthermore, this kind of program assists with the provision of public services in rural areas where large companies are hesitant to do business because there is not sufficient demand, infrastructure, or transportation services to warrant their attention.¹²⁸ The dual benefits of public service expansion and creation of demand for MSEs and SMEs can be achieved through this particular program.

Accounting for 60% of global GDP, international trade is a second option to expand demand.¹²⁹ Domestic markets have limited consumption potential, but global markets are continuously expanding at a rapid pace. Unfortunately informal economy is geared towards the domestic market and lacks a significant, diversified export base.¹³⁰ In fact, “an increase in the incident of informality by 10 percentage points in equivalent to a reduction in export diversification of 10 percent.”¹³¹ Informal businesses concentrate more in raw materials, goods in the early stages of production, and low quality items that have little export value; whereas formal companies are better equipped to produce higher quality, finished goods that are most demanded in international trade.¹³² Once formalized, businesses have access to the global economy. Global

¹²⁷ C.J. Schexnayder, "From small things: Peru wants procurement to bring small businesses out of the informal economy." *Latin Trade* (2006).

¹²⁸ Ibid.

¹²⁹ Marc Bacchetta, Ekkehard Ernst, and Juana Bustamante. *Globalization and Informal Jobs in Developing Countries*. Rep. 2009.

¹³⁰ Ibid.

¹³¹ Ibid, 9.

¹³² Ibid.

demand will sustain enterprises and give them opportunities for growth. This provides favorable circumstances for increased employment and profit.

Final Thoughts

A reform program that involves all of the above-mentioned aspects is incredibly complicated. Furthermore, it would be impossible to carry out all reforms at the same time. However, a holistic approach to formalization is decidedly more successful than isolated attempts.¹³³ Finally, it is important to keep realistic expectations about formalization programs and not expect overnight miracles. As with any large economic policy shift, there is bound to be some growing pains. Property rights and effective bureaucracy took hundreds of years to develop in today's advanced, industrialized nations. Institutions and people take time to respond to change and even longer to institutionalize it. That being said, developing nations should actively pursue formalization of the informal economy as part of their long term development and growth strategy.

¹³³ Garcia-Bolivar, 16.

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