



innovative policies for the urban informal economy



UNITED NATIONS HUMAN SETTLEMENTS PROGRAMME



UN-HABITAT



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6 CASE STUDY: MEXICO CITY

6.1 Introduction

Over the course of the past century, Mexico has experienced a rapid process of population and urban growth. From 1900 to 2000, the country's total population rose from 13.6 million to almost 97.5 million. As Figure 6.1 shows, over the same period, the percentage of the population living in urban areas rose from 28.8 percent to 74.6 percent.⁶¹ As a result, Mexico has been turned from a rural to a predominantly urban country. As has been the case with many other developing countries, this rapid urban growth was largely the result of mass rural to urban migration. This has led

to the emergence of one megacity – the Mexico City Metropolitan Area (MCMA)⁶² – and several cities with populations above 100,000.⁶³

One effect of the mass rural migration and the consequent rapid urban growth experienced in Mexico in general, and in the MCMA in particular, has been the proliferation of slums and irregular settlements around large urban areas. As recent UN-HABITAT reports have shown, the process of urbanisation across the world has been accompanied by a series of complex social, economic and cultural problems.⁶⁴ Some of the most

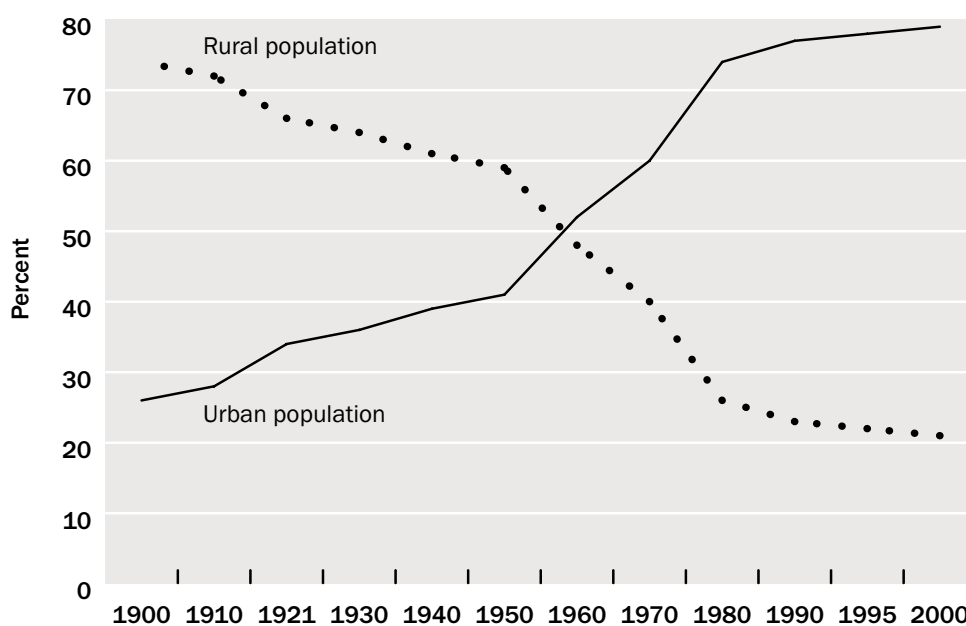
⁶¹ The criterion used to classify populations into urban and rural is the 2,500 inhabitant threshold commonly used in Mexico by INEGI. In particular, the population in localities with 2,499 or fewer inhabitants is classified as rural, while the population in localities with 2,500 or more inhabitants is classified as urban.

⁶² The Mexico City Metropolitan Area (MCMA) is comprised of all 16 administrative districts of Mexico City plus 35 contiguous municipalities located in the State of Mexico (one of the 32 federal entities that compose the country).

⁶³ A megacity is usually defined as an conurbation of over 10 million inhabitants.

⁶⁴ See, for example, the recent issues of the State of the World Cities report and the Global Report on Human Settlements.

Figure 6.1. Urban and rural populations as a percentage of the total population in Mexico: 1900-2000



Sources: National Population Census. INEGI

common problems among urban dwellers include high prevalence of poverty, crime, violence, homelessness, unemployment, substance abuse, pollution, environmental degradation, and the residents of the MCMA have not been an exception in this respect, notably with regard to the increasing urbanisation of poverty.

In the Mexico City Metropolitan Area as in many other developing countries, meeting their most basic everyday needs poses significant challenges to the poor. Part of these difficulties stem from the low levels of human capital that characterise the majority of the urban poor, which usually translate into low levels of income. The urban poor also generally lack proper access to basic infrastructure and public services, including drinking water, drainage, solid waste disposal, electricity, housing, telecommunications, roads, transportation, and education and health facilities (World Bank, 2005).

In addition to poor human capital and the lack of infrastructure and services, the urban poor must also confront the burdens imposed by the regulatory framework in which they operate, including rigid labour laws and burdensome regulations regarding the start-up, operation and bankruptcy of small businesses (de Soto, 1986). As a result, these laws and regulations typically exclude the urban poor from the protection provided by the social security and the judicial systems (de Soto, 2000) as well as from the benefits of access to the formal financial system (Mansell-Carstens, 1996).⁶⁵

6.2 National and Urban Dimensions of Mexico City's Informal Economy

This section provides empirical information regarding the informal economy, informal economy employment and informal employment as a whole in Mexico and the MCMA. It is based mainly on official national data, as well as on original analysis using the individual and household-level data from some of the household surveys collected by the Mexican national statistical agency (INEGI⁶⁶).

6.2.1 Measuring the Output of the Informal economy in Mexico and the MCMA

Since 2000, INEGI has been collecting and disseminating official data on the informal economy in Mexico, using the international statistical definition. Accord-

ing to this definition, the informal economy accounted for 12.4 percent of Mexico's gross domestic product on average during the period 1993-2002 (see Figure 6.2). One interesting fact that emerges from Figure 6.2 is that the share of the informal economy was relatively stable over that period.⁶⁷ Therefore, and contrary to conventional wisdom, the informal 'sector' has not been growing at a higher rate than the rest of the economy over the past decade, a fact that would have been reflected in an increasing share of GDP.⁶⁸

In terms of informal economy employment – a concept not to be confused with informal employment as a whole, which also includes informal employment in the formal economy and will be discussed in the next section – no time series are available from INEGI on the number of workers. Nevertheless, according to INEGI, in the year 2000 the number of informal economy employees was 9.1 million people, while the total labour force for the same year was 39.6 million people.⁶⁹ These numbers, together with the output of the informal economy as a share of GDP, imply that the typical productivity of the average worker in the informal economy is very low, since approximately 23 percent of the total labour force accounts for less than 12.5 percent of GDP.

The low average productivity of the informal economy has important policy implications. For example, Flores-Curiel and Valero-Gil (2003) analyze the tax revenue potential of the informal economy in Mexico. Based on its low average productivity and on estimates of the costs incurred by the government in collecting taxes, including the subsidies for those in the lowest ranges of income, they conclude that it would be more costly for the government to integrate the informal economy into the tax system than to allow it to continue outside of the system. A key question, then, is whether poor productivity in the informal economy is simply a reflection of the workers, or whether it is the result of impediments or barriers – including the

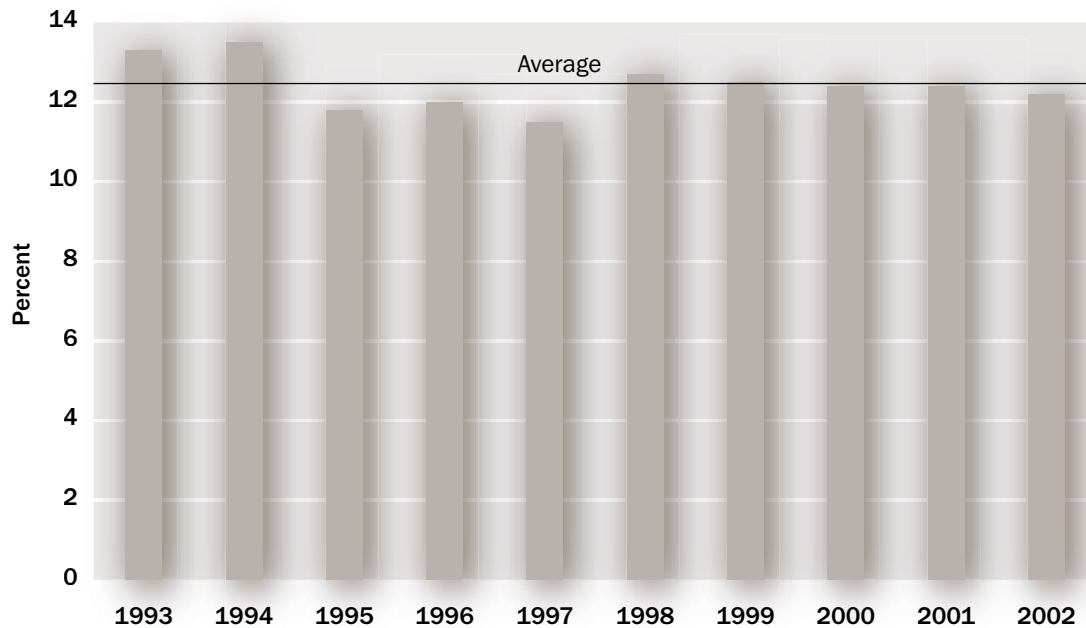
⁶⁷ In fact, there is a slight decline in the share of the informal economy in GDP between 1995 and 1997, which seems counterintuitive since this is the period following the balance of payments and banking crises that begun with the sharp devaluation of the Mexican peso in December 1994. One possible explanation for this is that the series for output in the informal economy and total output are deflated using different series. If so, the higher share of services in the informal economy (which are typically non-tradable goods), together with the sharp depreciation of the currency, could account for this decline.

⁶⁸ The evidence below on the share of informal jobs in total employment over the same period also suggests that the informal economy has not increased its share significantly. Moreover, the data from the National Income and Products Accounts on Gross Operating Surplus as a share of GDP, which includes the income of all informal employees, also suggests that the share of the informal economy has remained constant over the same period. See García-Verdú (2005b) for a more detailed explanation and evidence on this last point.

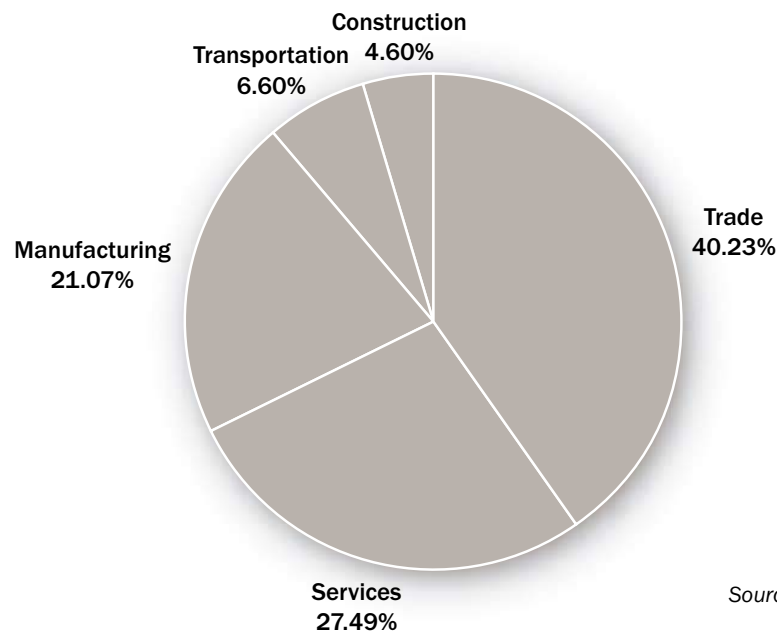
⁶⁹ The figure for informal economy employment in 2000 is from Instituto Nacional de Estadística, Geografía e Informática (2003b). The figure for the total labour force is from the National Employment Survey (Encuesta Nacional de Empleo).

⁶⁵ These benefits include, among others, the ability to smooth consumption over time and across states of nature through borrowing and lending, the diversification of risks, and a variety of payment services.

⁶⁶ INEGI refers to the Mexican National Institute for Statistics, Geography and Informatics (Instituto Nacional de Estadística, Geografía e Informática).

Figure 6.2. Value added of the informal sector of the Mexican economy as a share of GDP: 1993-2002

Source: INEGI Cuenta satélite del subsector informal de los hogares. Cuentas por sectores institucionales. Sistema de Cuentas Nacionales de México (various years).

Figure 6.3. Sectoral output as a share of total output of the informal sector in Mexico: average 1993-2002

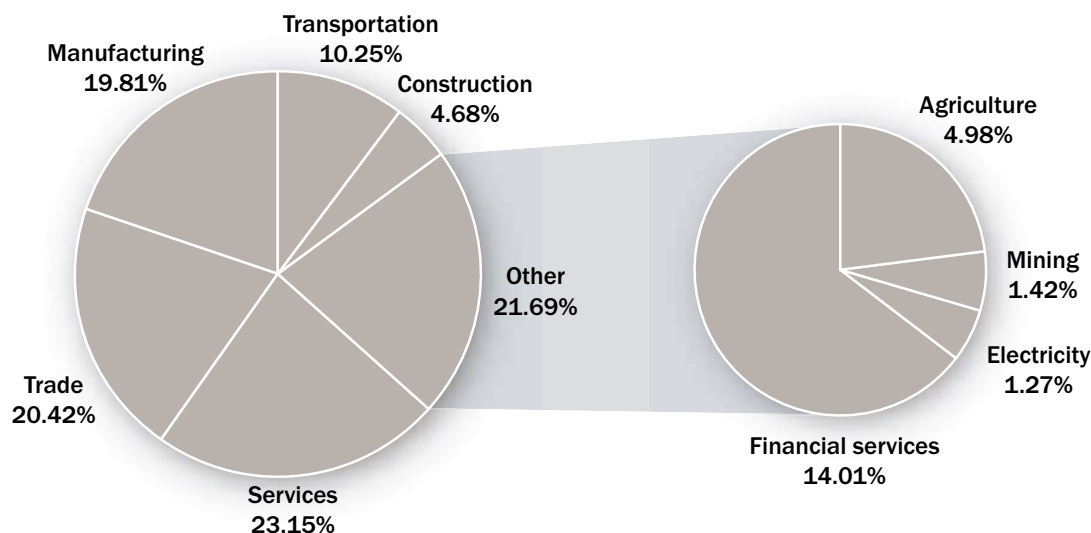
Source: INEGI, various years.

regulatory framework – which keep hindering the potential of the workers in the informal economy.

Regarding the sectoral composition of output in Mexico's informal economy, close to three-fourths of output originates in the tertiary sector (services, trade and transportation). In fact, trade and services alone account for nearly two-thirds of total output, while

manufacturing accounts for about one-fifth of the output of the informal economy. As Figure 6.3 clearly shows, the output of Mexico's informal economy is concentrated in the provision of services, rather than in the production of goods.

It is interesting to compare the composition of output in the informal economy with its equivalent in

Figure 6.4. Sectoral output as a share of total output of the Mexican economy: average 1993-2002.

Source: INEG, various years.

the economy as a whole. As Figure 6.4 shows, while the tertiary sector also contributes most (nearly 68 percent) to Mexico's total output, this share is smaller than in the informal economy (over 74 percent). Moreover, within the Mexican economy as a whole, tertiary activities feature sectors that are not found in the informal economy, notably financial services, which account for 14 percent of total output. Another important difference is that the share of trade in the output of the informal economy (40.2 percent) is almost twice as high as in Mexico's total output (20.4 percent).

Unfortunately, no reliable official data can be found on the magnitude or composition of output in the informal economy at the State or municipal levels. However, as the next section shows, available data on informal employment for the MCMA provide a useful insight on the dynamics of the informal economy in the Mexico City conurbation.

6.2.2 Measuring the Number of Informal Employees in Mexico and the MCMA

As discussed in Chapter 1, the international statistical definition of the informal economy can be rather restrictive, insofar as it tends to focus on unregistered and unincorporated enterprises. As a result, the ILO's expanded conceptual definition of informal employment, which is based on the nature of employment relationships⁷⁰, might provide a better picture of the extent of informality in Mexico City.

⁷⁰ As explained in Chapter 1, this expanded definition considers informal employment as characterized by lack of secure labour contracts, worker benefits or social protection, both inside and outside informal enterprises

Measuring informal employment in the MCMA is facilitated by the fact that the data in the 2000 Population and Housing Census make it possible to identify the employment status of each working-age member of a household, as well as their social security entitlements. According to the 2000 Census, 33.7 million people over the age of 12 performed some type of economic activity for one hour at least in the reference week and received some form of payment or compensation in return. The 2000 Census also shows that almost 53 percent did not have any form of social security benefits.

As shown in Table 6.1, in that same year but in the sole Mexico City conurbation (MCMA), 6.7 million people over the age of 12 performed some type of economic activity for at least one hour in the reference week and received some form of payment or compensation in return. Of these, 3.1 million people (or 46 percent of the total) did not receive any form of social security benefits.

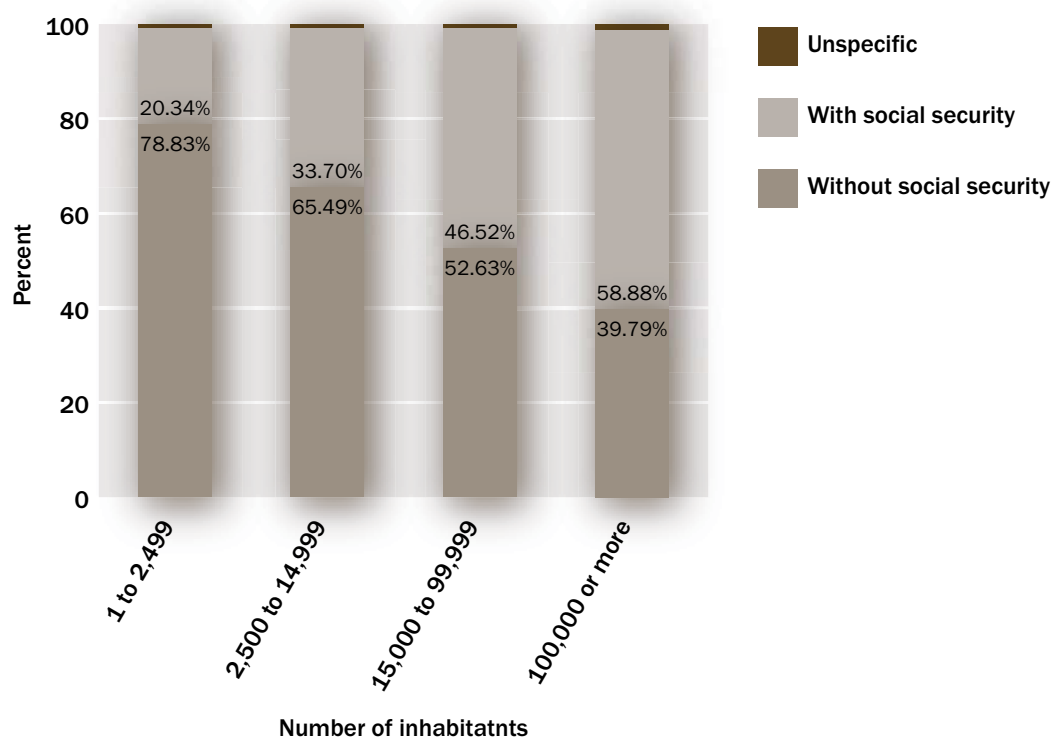
It is interesting to note that the MCMA has lower informal employment as a share of total employment than the country as a whole, and that Mexico City, in turn, has a lower share than the surrounding municipalities in the State of Mexico and consequently than the MCMA. This relationship should be viewed in the light of a more general pattern, according to which the share of informal employment tends to decrease with the population of the locality, as shown in Figure 6.5 (in terms of access to social security benefits). It is also significant that, based on this relationship between informal employment and lack of access to social security benefits, the MCMA has a higher share of informal employment than would be expected based on its population size. While 46 percent of MCMA's employed population lacked

Table 6.1. Employed population by social security status

Population	National	% Share	MCMA	% Share	Mexico City	% Share	State of Mexico	% Share
Employed population	33,730,210	100	6,741,675	100	3,575,708	100	3,165,967	100
Without SS benefits	17,765,996	52.67	3,110,425	48.14	1,584,636	44.32	1,525,789	48.19
With SS benefits	15,593,861	46.23	3,542,984	52.55	1,937,316	54.18	1,605,688	50.72
Not specified	370,353	1.1	88,266	1.31	53,756	1.5	34,510	1.09

Source: INEGI, 2000 National Population Census.

Notes: 1. The State of Mexico refers only to the population of the 35 municipalities which are part of the MCMA.
2. SS refers to social security

Figure 6.5. Employed population by social security status and by locality size in Mexico (according to the 2000 Census).

Source: Own calculations based on the Censo General de Población y Vivienda 2000. INEGI.

access to social security benefits, the average share of the population without social security benefits in Mexico's 32 largest metropolitan areas was 42 percent in the same year.

Within the MCMA, the shares of formal and informal employment in total employment vary greatly across districts and municipalities. As Table 6.2 shows, the share of informal employment across the various districts ranges from a high of 84 percent in Chiconcuac, in the State of Mexico, to a low of 33 percent in Azcapotzalco, in Mexico City. On aver-

age, the shares of formal and informal employment across Mexico City's 16 districts exhibit much less variation than those across the 34 municipalities of the State of Mexico. Given these wide variations in the shares of informal employment across different districts and municipalities in the MCMA, there is plenty of scope for the formulation and implementation of local or sub-metropolitan policies for the informal economy.

Table 6.2. Employed population by social security status in the MCMA districts and municipalities, 2000

Federal Entity	MCMA District or Municipality	Without Social Security (%)	With Social Security (%)	Not Specified (%)
Mexico City		44.32	54.18	1.5
	Azcapotzalco	33.15	65.73	1.12
	Coyoacán	39.62	58.15	2.23
	Cuajimalpa	52.12	45.4	2.48
	Gustavo A. Madero	43.11	55.77	1.12
	Iztacalco	42.06	56.77	1.17
	Iztapalapa	48.86	50.04	1.1
	Magdalena Contreras	45.76	52.65	1.59
	Milpa Alta	61.72	37.74	0.54
	Alvaro Obregón	45.84	52.38	1.77
	Tláhuac	46.62	52.32	1.06
	Tlalpan	46.42	52.08	1.5
	Xochimilco	49.22	49.48	1.3
	Benito Juárez	37.71	59.73	2.56
	Cuauhtémoc	42.65	55.79	1.56
	Miguel Hidalgo	42.17	55.17	2.66
	Venustiano Carranza	43.94	54.64	1.42
State of Mexico		48.19	50.72	1.09
	Acolman	53.63	45.34	1.04
	Atenco	58.61	40.95	0.44
	Atizapán de Zaragoza	43.63	55.11	1.26
	Coacalco de Berriozábal	34.49	64.79	0.72
	Coyotepec	45.41	53.69	0.9
	Cuautitlán	35.22	63.1	1.68
	Chalco	61.96	37.29	0.75
	Chiautla	70.81	28.24	0.95
	Chicoloapan	61.19	37.96	0.85
	Chiconcuac	84.12	15.18	0.7
	Chimalhuacán	65.66	33.59	0.75
	Ecatepec de Morelos	49.43	49.58	0.98
	Huixquilucan	56.22	36.56	7.22
	Ixtapaluca	45.03	53.68	1.29
	Jaltenco	47.39	51.17	1.44
	Melchor Ocampo	47.52	51.43	1.05
	Naucalpan	42.55	56.03	1.42
	Nezahualcóyotl	53.19	45.88	0.93
	Nextlalpan	77.79	21.54	0.67
	Nicolás Romero	44.73	54.66	0.62
	Papalotla	68.3	31.26	0.45
	La Paz	56.42	42.97	0.61
	Tecamac	55.8	43.48	0.72
	Teoloyucan	52	47.38	0.61
	Teotihuacán	59.82	39.37	0.81
	Tepetlaoxtoc	66.85	32.49	0.65
	Tepotztlán	38.79	59.2	2.01
	Texcoco	53.58	45.68	0.75
	Tezoyuca	60.58	38.81	0.61
	Tlalnepantla de Baz	39.09	59.71	1.19
	Tultepec	44.27	54.51	1.22
	Tultitlán	38.29	61.17	0.54
	Zumpango	59.88	39.64	0.48
	Cuautitlán Izcalli	33.87	65.19	0.94
	Valle de Chalco Solidaridad	64.27	35.13	0.6

Source: INEGI, 2000 National Population Census.

Table 6.3. Doing Business - Rankings in Selected Countries, 2005

Country	Ease of Doing Business	Starting a Business	Dealing with Licenses	Hiring and Firing	Registering Property	Obtaining Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business
New Zealand	1	4	2	4	1	7	1	16	15	4	21
Singapore	2	5	7	7	14	8	2	9	6	11	2
United States	3	3	17	6	12	15	7	30	17	10	17
Canada	4	1	21	24	27	10	3	12	13	34	4
Chile	25	23	35	37	30	32	36	63	42	41	82
South Africa	28	51	37	66	77	40	8	84	55	38	53
Spain	30	86	50	150	37	29	94	25	10	24	16
Czech Republic	41	77	87	60	57	21	68	70	24	21	101
Portugal	42	104	94	145	93	55	32	47	29	46	19
Poland	54	92	120	64	75	88	22	106	34	104	23
Panama	57	21	62	115	55	19	92	93	58	126	74
Nicaragua	59	65	72	80	110	71	72	130	50	22	55
Colombia	66	73	46	130	50	62	37	148	81	83	27
Peru	71	106	97	83	32	73	21	133	93	114	60
Mexico	73	84	49	125	74	68	125	95	39	100	22
Argentina	77	85	103	132	65	42	51	143	43	91	52
Brazil	119	98	115	144	105	80	53	140	107	70	141
Venezuela	120	95	96	71	47	76	142	145	91	129	129

Source: World Bank (2005).

6.3 Existing Regulatory Framework

State and municipal governments in Mexico have considerable influence over the regulatory environment in which enterprises under their respective jurisdictions must operate. For example, local governments in Mexico have considerable influence over the costs of starting and operating a firm, since they are responsible for issuing land use permits and licenses, including those related to health and safety, rights to use thoroughfares, and environmental regulations. States are also responsible for regulating public notaries, which are the only entities legally authorised by government to incorporate businesses formally and to register property.

Government employees are therefore responsible for sanctioning the large number of legal procedures required before any businesses can operate formally. These procedures include issuance of licenses and certificates which verify that the business complies with health standards, environmental regulations, zoning ordinances, labour codes and regulations, among others. In some cases, the bureaucrats in charge of the regulatory process use their positions to extract bribes and other illegal payments from businesses looking to comply with the regulations.

In other cases, bureaucrats may simply be resorting to inertia and imposing unnecessary costs regardless of the consequences.

This section examines some of the key regulations faced by the urban poor in both Mexico and the MCMA, and argues that the current regulations are burdensome and a hindrance to the development of business and the private sector. The major regulatory mechanisms can be regrouped into four broad areas: (i) incorporation and operation of businesses, (ii) labour legislation, (iii) social security contributions and (iv) issues related to good governance.

6.3.1 Doing Business in Mexico

The World Bank has developed a series of indices that rank countries according to the relative ease or difficulty of starting and operating a business in each country. The business dimensions considered are broad, and include: (i) starting a business; (ii) dealing with licenses; (iii) hiring and firing workers; (iv) registering property; (v) obtaining credit; (vi) protecting investors; (vii) paying taxes; (viii) trading across borders; (ix) enforcing contracts; and (x) closing down

Table 6.4. Doing Business in Mexico

State (City)	STARTING A BUSINESS				REGISTERING PROPERTY			
	Number of Procedures	Time (days)	Cost (% of income per capita)	Ease of starting a business (rank)	Number of Procedures	Time (days)	Cost (% of property value)	Ease of registering property (rank)
Aguascalientes (Aguascalientes)	8	32	7.3	1	7	29	3.2	1
Chihuahua (Ciudad Juárez)	9	35	32.3	4	6	34	3.2	4
Coahuila (Torreón)	9	39	16.1	6	8	50	4.3	12
Distrito Federal (Mexico City)	9	58	15.6	9	5	74	5.3	10
Estado de Mexico (Tlalnepantla)	8	46	73.9	10	7	48	6.1	11
Guanajuato (Celaya)	8	29	16.8	11	7	44	2.1	3
Jalisco (Guadalajara)	9	41	10.9	3	7	52	3.9	6
Nuevo León (Monterrey)	9	50	15.2	2	5	43	3.2	2
Puebla (Puebla)	9	49	22.1	13	7	69	4	7
Querétaro (Querétaro)	9	52	12	12	8	94	5.4	13
San Luis Potosí (San Luis Potosí)	10	41	15	7	8	34	4.1	9
Veracruz (Veracruz)	9	47	35.6	8	7	43	6	8
Yucatán (Mérida)	9	47	15.2	5	8	30	2.4	5

Source: World Bank (2006).

a business. These various indices combined provide a good indicator of the quality of the regulatory framework in a country and serve as a useful benchmark for performance comparisons across countries.

According to a report on the cost of doing business across the world (World Bank, 2005), Mexico does not provide a particularly favourable environment. Overall, Mexico ranks 73rd among 155 countries, according to the 'Ease of Doing Business' Index. The country does particularly poorly in three areas: (i) the difficulties that firms face in hiring and firing workers (125th out of 155 countries); (ii) the protection that the laws and the courts provide to investors (125th out of 145 countries); and (iii) the enforcement of contracts (100th out of 155 countries). As Table 6.3 illustrates, Mexico is ranked significantly below Canada and the United States, its main trading partners, as well as below other Latin American countries.

A more recent report on the cost of doing business in Mexico (World Bank, 2006) looks into the scope of regulations that enhance or constrain business activity in 13 Mexican cities in four areas of regulation, namely:

(i) starting a business; (ii) registering property; (iii) obtaining credit; and (iv) enforcing a contract. According to this study, Tlalnepantla (one of the most populous MCMA municipalities in the State of Mexico) and Mexico City ranked as the third and fourth cities respectively (on a sample of 13) where conducting business was most difficult..

As Table 6.4 clearly shows, Mexico City and Tlalnepantla perform particularly poorly when it comes to starting a business and registering property. For example, the average number of days needed to open a business in Mexico City (58) is higher than in any of the other 13 cities. Similarly, Tlalnepantla is the most expensive city in the sample to start a business, with the cost equivalent to about 74 percent of GDP per head. As for the number of days required for registering property, Mexico City takes on average 74 days, ranking only second worst behind Querétaro in the category. Finally, with regard to property registration costs as a proportion of property values, Tlalnepantla is the most expensive with an average cost of 6.1 percent, with Mexico City ranking fourth most expensive with 5.3 percent.

6.3.2 Labour Legislation Constraints

Labour legislation in Mexico is very detailed and intricate, being embodied in several pieces of legislation and running into thousands of clauses. It is also extremely outdated. The basic tenets of labour law are defined in Article 123 of the Mexican Constitution, which dates back to 1917, and the Federal Labour Law (LFT), which dates back to the 1930s, with a major revision in the 1970s. These two legal pillars have remained virtually unchanged over the years, with most of – only minor – changes tending to add to mandatory benefits and to reduce labour flexibility.

As in many other Latin American countries, Mexico's labour legislation is characterised by generous mandatory benefits and a high degree of job protection. Labour laws in the main require employers to comply with a number of regulations, provisions and restrictions, including minimum wages, minimum age of employment, maximum length of the working day, overtime pay, social security contributions, severance payments, seniority premia, maternity leave, on-the-job training provisions, non-discrimination policies and an obligation for employers to share profits with their employees, among others. Not surprisingly, the labour market is characterised by a high degree of non-compliance with these labour laws and regulations, as reflected in the high proportion of workers that are granted only some of the mandatory benefits, if any at all.

In view of labour unions' opposition to any changes, reforming Mexico's existing labour legislation is likely to be a challenge, including when it comes to implementation, and although such reform would likely have a significant impact on employment growth in the formal economy, as has happened in other countries such as Chile and Spain.

6.3.3 Social Security Constraints

Social security institutions are the main providers of health services and old-age pensions in Mexico. Despite this significant role, over half the labour force is not affiliated to any of the existing systems. Three main factors lie behind this relatively low coverage rate: (i) a high degree of fragmentation of social security into various schemes; (ii) high tax rates; and (iii) misalignment between contributions and benefits.

Social security in Mexico is characterised by a high degree of fragmentation. The multiplicity of schemes can be broken down into one of the following five categories: (a) private sector workers (IMSS); (b) public sector workers at federal level (ISSSTE, ISSFAM, State development banks, etc.); (c) public sector workers in State-owned enterprises (e.g. PEMEX, CFE, LFC, etc.);

(d) public sector workers at State level; and (e) public sector workers at municipal level. One problem with multiple social security systems is that each has its own accounting, actuarial and financial practices, as well as independent operating rules. The practical import is that benefits are not transferable across different systems. Given the high average rate of turnover between different jobs in Mexico, this highly fragmented social security system provides little if any incentive for informal workers to become formal: indeed, it is likely that at some point in their careers workers would lose some of the entitlements they have accumulated.

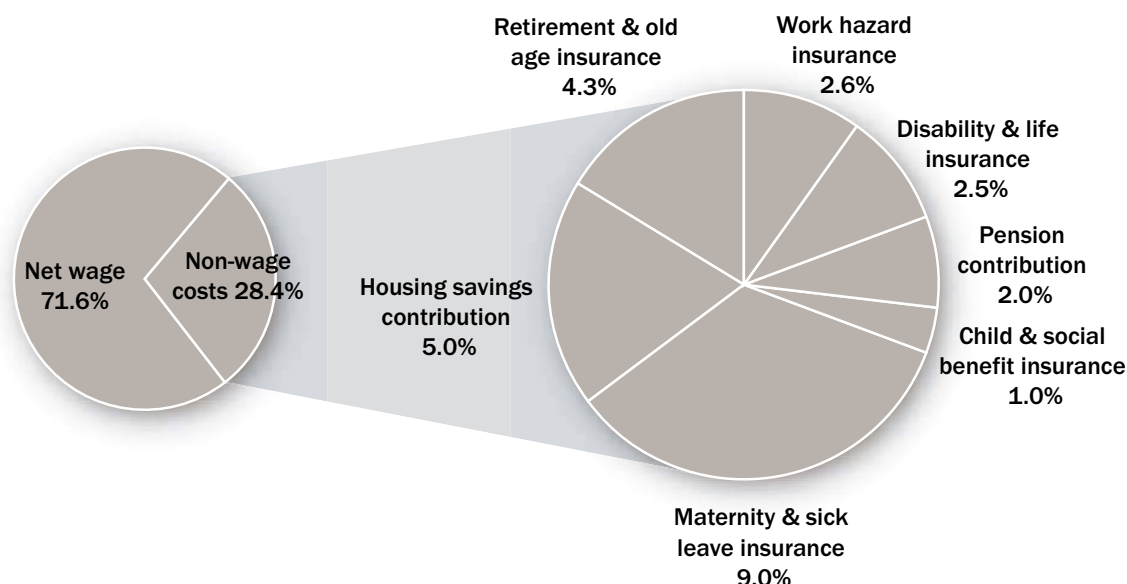
Another problem is the relatively high tax burden (on both employers and employees) that is associated with social security contributions. The non-wage costs deriving from the various payroll taxes and social security contributions introduce a very large gap between employers' overall wage costs and the net wages which workers end up receiving. As Figure 6.6 shows, non-wage costs amount to almost 30 percent of total labour costs. Therefore, high non-wage costs from the various payroll taxes and social security contributions also act as disincentives to formalisation.

The third major problem with Mexico's current social security system is that the benefits are ungenerous, particularly when compared with high contribution rates. These high non-wage costs have three major types of consequences: (i) on the Mexican economy as a whole, as they cause distortions in the allocation of labour in the economy; (ii) on the labour market, as they reduce the number of formal employees; and (iii) on the workers themselves, as contributions do not necessarily entitle them to high-quality social security services or adequate old-age pensions. The end-result is a significant misalignment between the contributions made by employers and employees on the one hand, and the benefits workers derive from the present system on the other hand.

6.3.4 Good Governance

It can be argued that Mexico's burdensome regulatory framework paves the way for corruption and bribery, as entrepreneurs look to sidestep the multiple procedures and eschew the costs imposed by the regulations. Indeed, the National Survey on Corruption and Good Governance (*Encuesta Nacional de Corrupción y Buen Gobierno*), published by the Mexican chapter of Transparency International, found that Mexico City and the State of Mexico were two of the most corrupt public entities in the country. According to the Index of Corruption and Good Governance (known as ICBG in Spanish), these two federal entities ranked as first and second, and then second and third, most corrupt entities in the 2001 and 2003 surveys, respectively.

Figure 6.6. Non-wage costs from various payroll taxes and social security contributions for private sector workers in Mexico.



Source: Instituto Mexicano del Seguro Social (IMSS).

Whether or not there is a causal link between the extent of corruption and the costs imposed by the regulatory framework, one thing is clear: in the case of Mexico there is positive correlation between the two, since the indices show that the MCMA maintains one of the most burdensome regulatory frameworks, and one the most corrupt environments, in the whole of Mexico.

6.4 Regulatory Reform: Innovative Policies and Practices

6.4.1 Simplifying Business Regulation

As the previous section has shown, the costs of setting up a business in Mexico City and keeping updated on current regulations can be substantial and therefore become a significant barrier to entry into city's formal economy.

Four major, distinct public policies can help reduce the cost of regulatory compliance and of formal (as opposed to informal) operations, in the process reducing the opportunities for corruption that arise from a cumbersome regulatory system. These policies can be summarised as follows: (i) reducing the number of procedures required to set up a business to only those deemed essential; (ii) streamlining any remaining regulatory procedures, taking into account both the direct and indirect attendant costs imposed on participants; (iii) introduction of new technologies, such as on-line procedures to incorporate

and register businesses, as well as other regulatory processes; and (iv) introduction of benchmarks to allow easy comparison across different regulatory procedures and across various government ministries or offices and various levels of government (federal, State and municipal). Last but not least, in order to speed up response times by government agencies responsible for relevant regulatory matters, it is recommended that more extensive use be made of the *afirmativa ficta* principle, under which if no response to a petitioner's request has been received within the legal deadline, then the decision is assumed to be favourable.

Many of these policies have already been adopted at the federal level in Mexico. Since 1989, in particular, the country's authorities have taken significant steps to streamline the regulatory framework. Prominent among these were the Economic Deregulation Programme of the Ministry of Commerce in 1989, and its transformation in 2000 into the Federal Commission for Regulatory Improvement (COFEMER) within the Ministry of the Economy.

COFEMER is responsible for supervision and review of federal regulations, although it has also supported State and municipal regulatory reform. For instance, as part of its support for regulatory reform at sub-national level, COFEMER regularly provides technical advice and training to States and municipalities. The commission has also been responsible for the publication – in cooperation with a leading public university in Mexico City – of a series of guidelines to advance regulatory reform at the municipal level. These guidelines

Table 6.5. Positive impact of SARE implementation in selected municipalities in Mexico: 2002-2006

Municipality	NUMBER OF DAYS		NUMBER OF PROCEDURES		VISITS TO OFFICES	
	Before SARE	After SARE	Before SARE	After SARE	Before SARE	After SARE
Los Cabos	35	1	16	5	10	1
Aguascalientes	29	1	7	2	6	1
Guadalajara	2	0.01	3	2	2	1
Zapopan	3	1	N.A.	1	3	1
Tlalnepantla	20	0.01	3	1	3	1
Oaxaca	42	3	6	3	6	2
Chetumal*	22.5	1	5	3	4	1
Puebla	58	2	27	5	5	1
Celaya	30	1	8	2	4	1
Ensenada	60	2	5	5	3	1
Tapachula	40	2	5	1	5	1
Campeche	25	2	2	1	2	1
Querétaro	21	2	3	1	5	1
San Luis Potosí	14	0.01	2	2	4	1
Mexicali	58	2	7	4	5	1
Uruapan	15	0.02	1	1	1	1
Morelia	15	0.02	2	1	2	1
Apizaco	20	1	10	3	5	1
Pachuca	20	2	17	9	2	1
Tehuacán*	45	3	17.5	2	4	1
Guanajuato**	37.5	1	5	1	4.5	1
Torreón	45	1	19	5	7	1
Average	28.86	1.28	8.12	2.73	4.2	1.05
Standard Deviation	16.8	0.93	7.05	2.05	2.02	0.21
Coefficient of Variation	0.56	0.73	0.87	0.75	0.48	0.2

Source: COFEMER

* For those municipalities that reported the information in terms of ranges, the number reported is the average.

** The number is the average of the distinct SARE schemes implemented in the State of Guanajuato.

include procedures for the establishment, at municipal level, of (i) an independent regulatory review authority; (ii) an independent regulatory review council; (iii) a procedure to assess the impact of regulations; (iv) a registry of business formalities; and (v) technical norms for the issuance of municipal regulations.

Complementing COFEMER's efforts have been those of the Centre for Private Sector Economic Studies (CEESP) of the Business Coordinating Council (CEE), which has been producing annual reports and indices on the quality of the regulatory framework in various federal entities since 1999. These indices are good benchmarks against which to compare regulatory performance across States and over time.⁷¹ As a result, they

have contributed to improve both the transparency and accountability of local authorities in Mexico.

In addition, COFEMER has assisted a number of States and municipalities looking to improve sub-national regulatory regimes through programmes similar to those implemented by federal ministries and central government agencies. As of December 2005, COFEMER had signed coordination agreements with all federal entities, as well as cooperation agreements with 92 municipalities throughout the country. One example of a successful policy designed to streamline State and municipal regulations is COFEMER's Rapid Business Start-Up System (SARE in Spanish). SARE is, in effect, a one-stop-shop which allows enterprises to comply with current regulations at all levels of jurisdiction (federal, State and municipal) through a single procedure which reduces to a maximum three the number of days before they can begin operating as formal businesses.

⁷¹ It is interesting to note that these indices also consistently rank both Mexico City and the State of Mexico among the federal entities with the lowest quality regulatory frameworks; the findings are supported by the above-mentioned Index of Corruption and Good Governance compiled by the Mexican branch of Transparency International.

As of early 2006, 89 Mexican municipalities had signed agreements with COFEMER to implement SARE and many of these systems are already fully operational. As Table 6.5 shows, the number of days needed to complete all the regulatory procedures has been significantly reduced in the municipalities where SARE is in force: the average period has fallen from close to one month to slightly over a day; and the average number of procedures has also fallen from over eight to fewer than three. In addition, the average number of visits to administrative offices has fallen from around four to a single one or so.

Based on aggregate data provided by municipalities, COFEMER estimates that implementation of SARE has already brought significant benefits to the Mexican economy, including increased capital expenditure (approximately USD915 million as of January 2006) the creation of some 157,000 new jobs and the incorporation of over 60,000 additional firms. Therefore, SARE comes out as an innovative scheme whereby municipal regulation is mainstreamed with broader socio-economic objectives such as accelerating urban economic growth, generating jobs and ultimately enhancing urban incomes. Compared to other initiatives intent on regulating informal enterprises on a piecemeal basis – such as relocation of informal street vendors to official markets (see section below) – SARE has the advantage of ensuring a permanent and economy-wide change in the regulatory regime. The potential to promote the regularisation of informal enterprises is therefore much greater than it is with piecemeal schemes.

An additional benefit of SARE is that it does not favour any one particular social group at the expense of another. Such discrimination is a serious concern with regard to women, as some relocation programmes have been shown to benefit men more relative to women, even though unintentionally. In addition, SARE appears to be sustainable in the long run, since it is based on formal agreements between COFEMER and municipal authorities that guarantee its continuity. Furthermore, the potential for replication is high, since SARE does not rely on significant expenditure by municipalities. This may be one of the reasons that an increasing number of Mexican municipal authorities are joining the programme.

However, implementing SARE requires some minimum capacity from municipal authorities, which is why current participants tend to be larger towns with relatively high average incomes per head. Therefore, the federal government should consider complementary measures – including capacity-building programmes – to assist introduction of SARE in smaller or poorer municipalities.

In any case, it is clear that SARE is not a panacea when dealing with informality in Mexico City.

For example, the above-mentioned economic benefits cannot be ascribed to SARE alone, since some of the expenditure and job creations would have taken place regardless. Still, those economic benefits are suggestive of the high potential of SARE when it comes to promoting the incorporation of informal enterprises and the creation of formal jobs.

For all the regulatory streamlining that has taken place at sub-national level, several challenges remain. The agreements between COFEMER and local authorities are encouraging, yet much remains to be done – as shown by the fact that out of the 2,429 municipalities in Mexico, to date only 92 have signed cooperation agreements with COFEMER and only 89 have actually implemented the SARE system.

One crucial element, as highlighted in a recent OECD (2004b) report, is the procedure required to obtain individual tax identification numbers, which remains cumbersome and often takes more than a month to complete. Another significant regulatory burden is the relatively high cost of incorporating a firm, largely because of lack of competition among public notaries. Moreover, whereas issuance of tax identification numbers is a federal prerogative, regulation of public notaries is the responsibility of State governments. This situation calls for greater coordination of regulatory policy reform at federal, State and indeed municipal levels.

6.4.2 Reforming Labour Legislation

The experience of other comparable countries, such as Chile and Spain, shows that streamlining labour legislation can also encourage business formalisation. Due to Mexico's burdensome laws in this area, making the labour market more flexible seems to be an inescapable requirement. One avenue is to introduce more flexible terms and conditions, such as the fixed-term contracts introduced in Spain which do not entail any severance payments for the duration.

Another significant area in need of reform involves the intricate procedures for labour disputes. The current arbitration and mediation process is very slow and uncertain, both for employer and employee. The experiences of Chile and Spain, which have introduced oral court proceedings and have effectively reduced the length of the process, should prove all the more valuable as these countries' legal systems are relatively similar to Mexico's. Another worthy innovation could be the substitution of the current high and burdensome severance payments with a system of unemployment insurance based on tripartite contributions (employers, employees and possibly public authorities).

6.4.3 Reforming Social Security

The fragmentation of the social security system in Mexico calls for concerted reform to ensure that benefits are at least transferable across different schemes. The Individual Retirement Accounts (IRAs) introduced under the System for Retirement Savings (*Sistema de Ahorro para el Retiro*) in 1992, along with the reform of the Social Security Law in 1997, have helped mitigate this problem as they allow workers to recover a larger proportion of the benefits in case they leave the system. Nevertheless, it is important to remember that so far the reforms have only benefited private sector workers (IMSS), and then only to a limited extent as they are not assured of the minimum guaranteed pension unless they remain in the formal sector for a very long part of their careers.

In this respect, the 'portability' of pension contributions could effectively be enhanced if all the other systems were turned from pay-as-you-go (PAYG) or defined-benefit to fully-funded or defined-contribution schemes. Once IRAs have been introduced for all pension schemes, rules must ensure portability across systems. Since all PAYG systems are rapidly becoming unsustainable due to an aging population, they are all likely to need to go down this avenue at some point.

The financial conditions of the main social security systems in Mexico suggest that it will be very difficult, at least in the short run, to reduce relevant contributions or taxes significantly. Consequently, the only feasible option is to tighten the link between contributions and benefits through improved quality of services. Currently, one of the main obstacles to health service improvement is the collective labour contract with IMSS workers; a re-negotiated contract could introduce more flexibility and enhance productivity in this area.

As far as old-age pensions are concerned, competition among private pension fund managers (*Administradoras de Fondos de Pensiones*, or AFORES) has so far been limited and therefore must be increased. Over the past decade, the trend has been one of consolidation, leaving the business concentrated among a few large participants, as has happened in the financial/banking sector as a whole. The practical outcome for savers is a combination of high fees and relatively low net rates of return on contributions. Encouraging more competition among pension fund managers would surely improve net returns for the saving public.

6.4.4 Micro- versus Macro-Policies

As shown earlier, more than half of the labour force in Mexico and the MCMA are in informal employment, a share that has remained relatively constant over the

past years, although the economy has experienced episodes when GDP per head has grown above trend. The inability of the economy to create sufficient formal jobs to absorb fresh entrants into the labour force – even during periods of strong economic growth – suggests that the factors behind the expansion of the informal economy in both Mexico City (or the MCMA) and the country as a whole are of a structural rather than cyclical nature.

In the MCMA, most of the public policies that have been implemented at the State, municipal and district levels to reduce the prevalence of informality have been partial and have not addressed the structural causes. For example, some of the major schemes, such as the relocation of street vendors and street markets, seek to alleviate the symptoms of informality rather than the structural factors behind it. Not surprisingly, these micro-policies and programmes have failed to reduce the magnitude of the informal economy.⁷²

In most instances, the success of relocation programmes has been only temporary, since many of the original street vendors were prompt to return to their old locations, or new vendors quickly took their place. Even such relocations have been extremely difficult to conduct, as street vendors typically oppose these schemes, and violently so on occasion. Moreover, relocations are, at best, a partial remedy, as they affect only a small proportion of the millions of informal workers in the MCMA.

Paradoxically, some of the policies that may have contributed most effectively to the reduction in the share of the informal economy, and that are likely to continue doing so in the near future, are macro-economic policies that were not primarily intended to address this problem. This is the case, for example, with the recent expansion of the financial system in Mexico, which has experienced a significant deepening over the past five years. After a protracted period of economic turmoil following the December 1994 currency and financial crisis, the return to stability has been gradual: inflation has been reduced to single-digit levels while nominal and real interest rates have fallen significantly. As a result, credit to the non-banking private sector, particularly consumer and mortgage credit, has been expanding at double-digit rates over the past five years. Renewed access to credit, together with the fact that it is more readily extended to those in the formal sector, may be one of the most important incentives for own-account workers and informal employees to

⁷² In some instances, politicians, legislators and policy-makers have even suggested that informality should be "solved" or "remedied" by decree, such as through registration, regulation and taxation of informal vendors, or even prohibiting their activities altogether. See Cross (1998) for a description of some of the policies implemented in the MCMA to relocate informal street vendors as well as a discussion of some of the factors that may lie behind their failure.

enter formal employment. The main reason is that credit in general, and mortgage credit in particular, is more likely to be extended and is usually available on better terms to formal workers.

Given the magnitude of the problem and the poor results of most public policy solutions so far, the focus should shift to public, and notably macro-economic, policies that: (i) are broad in scope, in the sense of affecting most if not all of the targeted population; and (ii) are structural in nature, addressing the structural causes of the informal economy, not its symptoms.

6.5 Conclusion

With the trend decline in the MCMA share in Mexico's total manufacturing output, as well as in manufacturing jobs as a proportion of total employment in the country as a whole, informal employment is likely to increase its own share of total employment in the MCMA in the future – unless, that is, effective measures promote the regularisation and formalisation of informal enterprises. As this chapter has shown, the regulatory costs of establishing and operating a business in Mexico act as a serious barrier to entry and a formidable obstacle to formalisation.

Besides complementary measures to reduce the burden of labour legislation and the social security system on formal enterprises, regulatory reform should focus on current regulations at the federal, State and municipal levels, particularly those related to starting, operating and closing a business, as well as granting licenses and permits.

At the same time, the decision made by COFEMER to establish a formal review process for new regulations as well as a formal registry of procedures should not remain isolated. All federal ministries and sectoral regulators should similarly identify their main regulations, perform impact assessments of new regulations and propose improvements. This type of systematic review would improve both the rationale and efficiency of new and existing regulations.

At municipal level, COFEMER's Rapid Business Start-Up System (SARE) can be considered as one of the most promising innovations as far as streamlined municipal rules are concerned. Mexico's membership of the Organisation for Economic Cooperation and Development (OECD) has also proved very useful in this respect, as the agency makes periodical reviews of the quality of member countries' regulatory frameworks (OECD, 1999, 2004(b)).

With regard to the regulatory framework in the MCMA in particular, it is important to recall that several distinct regulatory regimes correspond to different levels of jurisdiction. As highlighted in a recent

OECD (2004a) report, the different administrative and regulatory regimes in Mexico City and adjacent MCMA municipalities in Mexico State have given rise to fiscal and regulatory asymmetries, with an attendant lack of coordination between public authorities when it comes to devising a metropolitan regulatory environment in tune with the needs of a competitive urban economy.

Although a full analysis of the differences in the administrative and regulatory regimes between the Federal District (Mexico City) and the State of Mexico lies beyond the scope of this case study, it is important to stress that these asymmetries may, in some cases, lead to regulatory arbitrage by individuals or firms in order to avoid regulatory compliance. Asymmetries and incentives for arbitrage, combined with the lack of coordination between State and local governments, are some of the factors behind poor compliance with many of the current regulations in Mexico City.

Based on the evidence and analysis provided above, it is clear that several of the policy reforms proposed in this chapter have the potential to improve the welfare of millions of poor urban dwellers in the MCMA who are currently being excluded from the benefits of formality including, in particular, a regulatory environment that facilitates the establishment and operation of formal businesses.

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