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The Informal Economy in Mexico: An Alternative Labor Market

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Introduction

Almost inadvertently, Mexico's informal economy has reached a worrisome size that no society or government can wish away as a simple statistic. Today, three out of 10 Mexicans earn their livings in the informal economy. This article will develop the premise that the regulatory framework has lagged behind the economy's increasing dynamism, making the informal economy an attractive alternative for a large number of families in Mexico. On an institutional level, the debate about the informal economy has its origins in the 1972 International Labor Organization's Kenya Report. More than 30 years after this document was published, the informal economy has become a universal problem. In different ways, the non-structured, hidden or underground economy – as it is also known in other countries – takes different shapes according to each country's geography and socioeconomic conditions. Latin America and Mexico in particular, have been no exception. Mexico's informal economy began to be tallied by Labor Ministry reports in 1979. Today, 28.2 percent of the employed population in Mexico works in the informal economy. This is the same as saying that 11,865,000 people carry out their economic activity outside any regulatory framework. Also, the informal sector represents almost 12.2 percent of the economy's total gross value added, but of even greater concern is the growing emergence of informal micro-business from 2002 to 2004 in contrast with the decline in formal micro-business in the same period. According to data from the Mexican Social Security Institute (IMSS) and the National Statistics Institute (INEGI), during those years, almost 260,000 informal micro-businesses were created, while 10,176 formal ones disappeared.

No consensus on defining informality

Defining the term informality is complicated. Different authors have dealt with it according to their object of study, without coming to any consensus. However, one way or another, informality implies economic activities that do not comply with a country's legal regulation; in the Mexican case this may be Finance Ministry regulations, or those of the Social Security Institute, the banking system or chambers of commerce and industry¹. However, the definition of the concept of informality cited in the previous paragraph continues to be ambiguous since a company that does not comply with only one regulation has a different impact from one which ignores the regulatory framework altogether. In other words, informality cannot be defined in terms of all or nothing, but must be conceived of as a continuum on which companies' behaviour oscillates between compliance and non-compliance with certain regulations. Naturally, it is important to delimit the object to be defined, whether for economic research or for designing a specific public policy. For the effects of this article, we will stick to the definition used by the INEGI, which considers companies and workers to be part of the informal sector when they are part of the non-structured part of the economy.

Very often informality is confused with itinerant and street sales, a completely justified confusion since this activity is one of the most important in Mexico's informal economy, the fastest growing and undoubtedly the most visible: itinerant sales grew 11 percent annually between 2000 and 2004, expanding by 135,000 persons a year according to the National Employment Survey. However, Mexico's informal sector is much larger and more complex. According to the last *Cuenta Satelite del Subsector Informal* (Satellite Account of the Informal Sub-Sector), published by INEGI in 2002, gross out-put in this sector came to 987.55 billion pesos in that year. But when this sum was broken down by kind of economic activity, "trade and informal restaurants and hotels" (which includes itinerant and street sales) accounted for 318.90 billion pesos, or 32.3 percent of the total. This means that there are other kinds of informal activities that cannot be left out of any serious analysis, particularly considering that "services" and "manufacturing" represented 33.8 percent and 18.1 percent respectively of the informal sector's gross output.

The informal economy: an attractive alternative job market

In June 2002, William Maloney presented a research document at Stanford University about the Mexican labor market. He came to several interesting conclusions for understanding why informal job opportunities continue to exist. First of all, he says that the Mexican labor market is highly dynamic, considering the relatively rapid turn-over rate for workers changing from one job to another. More concretely, in manufacturing, workers remain in the same job for an average of five and a half years, a relatively short time in comparison with other countries.

¹ By regulations, we understand forms of long-term contracts in which institutions offer services to companies, which in Exchange must pay fees or taxes. That is, there is a supply of regulations that are then demanded by every economic unit and, therefore become part of their productive process. See Eugenio Rivera Urrutia, "Teorías de la regulación en la perspectiva de las políticas públicas", *Gestión y Política Pública*, no. 2, vol. 13 (2004).

It is even more surprising to see that in a six-month period in the same sector, 85 percent of workers who changed jobs had resigned, not been fired or laid off. A large number of these workers end up self-employed or with a job in the informal sector. Maloney reports that by 1992, in the middle of an economic boom in Mexico, 70 percent of those who left their formal jobs to go into the informal market did so to increase their incomes or achieve more flexible working conditions.

Although it is often thought that wages in the formal sector are higher than in the informal sector, this is questionable. The first figure that brings this into doubt is the fact that in 1992, formal sector workers who went into the informal sector reported an increase in income of around 25 percent, while those who moved from the informal to the formal sector only reported an increase of 15 percent. The differences in income between the workers in the two sectors can be explained mainly by three factors: those in the informal sector must earn more since they need to compensate for the lack of fringe benefits afforded by jobs in the formal sector; secondly, they must also have higher incomes because of the risks they run, the implicit costs of the capital they invest and the value of unpaid work by family members who work in their informal economic activities; and third formal sector workers' gross wage would tend to be greater than those in the informal sector to compensate for the former's paying taxes. For this reason, it is not necessarily clear in which sector workers earn more.

With regard to the fringe benefits afforded to workers with formal sector jobs, it is not clear if they compensate for the dues or deductions in the wages that must be paid. To quote one paradigmatic example, when a worker signs up with the IMSS, he/she receives medical coverage for him/herself and some members of his/her family. This implies that a second family with a formal job whose pay check deducts the IMSS fees for his/her membership receives no benefit (because he/she is already benefiting free from the first family member's deduction), and therefore he/she will avoid at all costs paying the fee (thus earning less) to be signed up with the IMSS. This is the same as saying that this second – or third or fourth – family member will prefer a job classified as informal in which he/she will not incur these costs.² Finally, it is important to emphasize that between 1990 and 1992, when the Mexican economy enjoyed sustained growth, formal employment shrank and informal employment expanded.³ What is more, wage increases in the informal sector surpassed those of the formal sector (relative wage increases). While these figures are not conclusive, at least they show that informal employment has become an attractive alternative for a large number of Mexicans.

² To explain what we mean by “second family member” let us look at an example: if in a four-person family (father, mother and two children), the father is affiliated to the IMSS, the mother has no incentive to work in a formal job (and therefore receive the benefit of medical care) since it is sufficient to have one family member signed up with the IMSS to get coverage for the entire family. This is why this study says that this is the reason someone in that situation would prefer an informal to a formal job, since he/she would prefer to not pay for the cost of health care and other social benefits.

³ GDP growth in 1990, 1991 and 1992 was 4.4 percent, 3.6 percent and 2.7 percent, respectively.

Why go into the informal sector?

Informal employment being perceived as an attractive alternative for a large percentage of the active work force does not mean that we are inevitably condemned to informality. Public policies do exist that can contribute to making the formal sector more attractive than non-structured sector. According to Maloney's study, companies decide on different levels of formality because they incur different costs and benefits from regulatory requirements.⁴ Smaller companies tend to demand less participation in the institutions of formality since their relative costs are higher and they receive fewer benefits. An examination of the information gleaned from different surveys about Mexico's informal sector shows that small companies tend to have three specific characteristics: they are new; they have limited information about the markets they are immersed in; and, therefore, they run a high risk of going bankrupt. These three variables, together with their very inefficient operations, result in their opting to vary more or less from formal functioning. That is, as Maloney said, causality goes from inefficiency to informality since these small, new companies, it is unclear whether paying the costs of formality is worth it. As they grow, the likelihood that they will go bankrupt lessens and, analogously, their need to obtain the benefits of formality (such as legally binding contracts, access to capital and the entry into larger markets, just to mention a few) increases.

However, the cost of formality is by no means a constant; rather, it varies according to each country's regulatory framework. There is a general consensus that an improvement in institutional quality decreases the size of the shadow economy.⁵ The World Bank *Doing Business* studies aim to investigate the way in which regulations are incentives for or a brake on entrepreneurial activities in different countries, with the aim of proposing reforms to facilitate the opening of businesses to create new job opportunities.⁶ In order to evaluate a country's regulatory framework, the study presents comparable quantitative indicators of conditions and help available for opening businesses there; these indicators are used as tools of economic analysis to identify the reforms needed to create those conditions. The result of the study puts Mexico in seventy-third place worldwide (barely above El Salvador, Jordan and Sri Lanka), while countries like Kenya, Peru and Uganda have better regulations. It is worth pointing out that two most alarming aspects of the Mexican regulatory framework are "protection of investors" and the "flexibility of the labor market". Mexico occupies 125th place for both indicators and is comparable to Haiti, Jordan, Senegal and Guatemala. However, we should recognize that with regard to "ease of closing a business", Mexico's regulatory

⁴ W. F. Maloney, "Distortion and Protection in the Mexican Labor Market", at <http://scid.stanford.edu/pdf/credpr138.pdf>

⁵ See Alex Dreher *et al.*, "How Do Institutions Affect Corruption and the Shadow Economy", at <http://econwpa.wustl.edu:8089/eps/pe/papers/0502/0502012.pdf>. Also recommended is the article by E. Friedman, S. Johnson, D. Kaufmann and P. Zoido-Lobaton, "Dodging the Grabbing Hand: The Determinants of Unofficial Activity in 69 Countries", *Journal of Public Economics* 76 (2000), pp. 459-493.

⁶ World Bank and the International Finance Corporation, "Doing Business in 2006: Creating Jobs", (Washington D.C.: World Bank/International Finance Corporation, 2005).

framework occupies twenty-second place, comparable to New Zealand, the United States, Sweden and Denmark.

The alarming thing is the odyssey and average citizen would have to undertake to open and operate a formal business in Mexico. According to *Doing Business 2005*, an entrepreneur who wants to open a business and comply with all the regulations would have to go through 58 days of red tape, carrying out nine different procedures, even today when the government SARE program is up and running⁷. If the businessman or woman had to register his/her property, it would take him/her 222 days to carry out 12 different governmental procedures. If this hypothetical entrepreneur managed “to survive” all of this and wanted to pay taxes from his/her first day of operations, it would take him/her 536 hours to make 49 different payments. Even more, if he/she had to lay off staff, it would cost him/her the equivalent of 74 weeks wages per worker. Finally, if the company had to enforce a contract, it would take 420 days to carry out 37 different procedures to get a resolution. Most probably, whoever attempted to open and operate a business would opt for some degree of informality along the way. That is, he/she would decide not to comply with one or another of Mexico’s regulations. In summary, opening up a fully formal business in Mexico would require an inexhaustible store of patience.

Final considerations

The shadow economy should not be neglected; it is a priority on the country’s political and economic agenda. The next administration will have to be clear that unofficial activity is a worldwide phenomenon which is difficult to explain and today is part of many of the country’s economic activities. It will also be necessary to take into account that informality can be explained as a way forward that is an attractive alternative and not necessarily the response to a lack of growth. Therefore actions must be aimed at improving the regulatory framework, which has a direct impact on the size and nature of this phenomenon, to make it less costly to become part of the formal sector of the economy. That is, making it easier to access formality as a way to fight informality. The public policies the country demands for the next presidential term – particularly in fiscal and labor matters and the simplification of the regulatory framework – cannot wait. If they are well designed and implemented, Mexico runs three risks: questioning the rule of law and therefore negatively affecting flows of foreign direct investment; weakening tax collection; and putting a growing sector of the work force at risk in terms of their labor rights. If this is not dealt with, these risks will eventually translate into a drop in living standards.

⁷ The SARE program stands for the Quick Company Opening System, a program of the Federal Commission for Regulatory Improvement (COFEMER), which went into effect March 1, 2002.