

**BACKGROUND PAPER--BARRIERS TO PARTICIPATION: THE INFORMAL
SECTOR IN EMERGING DEMOCRACIES**

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1.0. INTRODUCTION

The recent trend towards democracy and market-based systems has improved the lives of millions across the globe. Many countries have increased political participation, achieved macroeconomic stabilization and restored growth. Despite these achievements, millions of people in emerging democracies remain excluded from the political and economic system and still live in poverty. A glaring symptom of this exclusion is the growing number of entrepreneurs who are engaged in low-income, low-growth business activities outside the formal economy. These citizens feel that democracy and market-based economy have not brought them the expected benefits.¹ As a result, an increasing number of citizens in emerging democracies and economies are disappointed and disillusioned.

In order to consolidate democratic and market-oriented transitions, it is imperative to understand why this is happening and then to devise viable solutions. The underlying reason why many citizens in emerging democratic, market systems do not participate in the political system or the formal economy is that the institutional structures or the “rules of the game” prevent them from doing so. In other words, there are barriers to participation in the formal political and economic systems.

These barriers exist in spite of democratic elections for public offices. Holding free and fair elections regularly is the essential first step towards a participatory political system. The next step, removing obstacles to routine, daily public participation in national and local decision-making— is receiving increased attention worldwide, and is essential to improving the practice of democratic governance. One series of policy recommendations for opening the governance process to democratic participation comes from the Sana’a Declaration adopted by over 30 emerging democracies.² Until the barriers are removed, democratic governance and economic growth will continue to be hindered.

This paper focuses on one type of barrier to political and economic participation: the cost of doing business in the formal economy and will discuss how these barriers jeopardize the consolidation of democratic and economic transitions. Examples of the costs of conducting business in the formal sector include:

- obtaining a business license
- acquiring land titles or leases
- hiring employees
- knowing and complying with applicable government laws and regulations

¹ Johnson, Kaufmann and Shleifer (1997) provide statistics showing that in Poland and the Czech Republic macroeconomic stabilization and economic growth did not lead to a smaller informal sector. What is needed, they argue, is depoliticization and institution-building.

² The Sana’a Declaration is a list of recommendations crafted by representatives of all different sectors of society from 16 emerging democracies. It was designed to further economic and political reforms and to consolidate democracy. See Appendix A for the full text of the Sana’a Declaration.

- obtaining information about the price, quality and quantity of particular goods and services, about sources of goods and services, and about potential customers
- obtaining a loan
- buying supplies
- hooking up and maintaining electricity and telephone services
- paying taxes
- enforcing contracts, and so forth.

These costs are often referred to as transaction costs.³

Key determinants of transaction costs in a particular country are the institutions, i.e., the rules and regulations that affect economic activities. Well-designed institutions provide entrepreneurs with a predictable framework and necessary business information at a cost that encourages them to comply with and pay for these institutions. Poorly designed institutions require entrepreneurs to comply with burdensome rules and regulations and deal with inefficient, corrupt government agencies, and offer few benefits in return. Such institutions increase transaction costs, lower entrepreneurs' incentives to comply, and hinder political and economic participation.⁴

One of the most important institutions contributing to the success of capitalism is the formal property rights system. This system provides the legal mechanisms through which assets can be converted into capital and used to create additional value, increase productivity and growth (see De Soto 2000). While virtually every country has a formal property rights system and acknowledges its importance, in developing countries the general public does not benefit from such institutions for two reasons. The first is that formal law has often been crafted by (and for) an upper-class minority and thereby does not reflect the concerns and norms of the general public. The second reason is that the enormous costs in terms of time and money necessary to acquire formal property rights in developing countries often outweigh the benefits. Entrepreneurs of modest means without political influence simply do not have the resources or the incentives to comply with costly laws and regulations--including obtaining formal property rights, acquiring a business permit or maintaining legal accounting records. Locked out of formal, wealth-creating institutions, these entrepreneurs operate informally in small-scale, short-term,

³ Abstractly, "transaction costs include the costs of obtaining and verifying information about the quantity and quality of goods and services, the partners in a transaction (and verifying their reputation, records, etc.), and the quality of their property rights to be transferred, including the legal and contractual framework; as well as costs of designing, monitoring, and enforcing the contract of transfer, including any costs incurred in litigation and dispute resolution. Some of the costs are insurable; that is, insurance costs are also part of transaction costs" (Burki and Perry et al. 1998:141). See also Coase (1937), Niehans (1989:320), North (1992:27) and Williamson and Masten (1999:142).

In the 1930s, Ronald Coase pointed out that one of the shortcomings of neo-classical economics is that it assumes that entrepreneurs have cost-free access to complete information and consistent, comprehensive enforcement. Because this is not the case, institutions are needed to provide information and enforcement yet this incurs costs. Coase (1937) was concerned with how these costs affected the organizational structures, vertical versus horizontal integration, of private businesses. His pioneering work on transaction costs initiated the new institutional economics.

⁴ Taneja and Pohit's (2000) study of informal sector trade between Nepal and India implies that such activities will continue until the formal sector transacting environment improves.

low-investment and low surplus-generating activities or they do not engage in business at all. This greatly hinders growth.

Moreover, these entrepreneurs are often excluded from policymaking or lawmaking processes. As a result, government is not held accountable to their concerns and democracy is weakened. This creates an opportunity for a small number of politically active oligarchs to control the nation's economy through a system of politically-motivated, state-endorsed laws and regulations at the expense of the rest of the population who eke out a living in the informal sector.⁵ “To the extent that excessive regulations are created to benefit particular interest groups and not society in general, the presence of the informal sector is a result of the failure of political institutions to protect and promote an efficient market economy”(Loayza 1997:2). In addition, lack of democratic and market-based institutions imperils the competitiveness of an economy and weakens its ability to take advantage of globalization.

In short, poorly designed institutions bar entrepreneurs from or discourage their participation in the political and economic system. Hence, they operate in the informal sector. This has serious implications for the future of political and economic transition in emerging democracies and economies and thus warrants attention.

For this reason, CIPE has recently devoted increased attention to reforming key political and economic institutions in order to encourage and enable informal sector entrepreneurs to participate actively in the formal market economy and policy making process of emerging democracies. To this end, CIPE sponsored a workshop on the informal sector that was part of the National Endowment for Democracy's Second Global Assembly of the World Movement for Democracy in São Paulo, Brazil in November 2000 (see www.wmd.org). In preparation for this event, CIPE prepared an earlier version of this background paper and sent it, prior to the event, to those who had signed up for the workshop. The workshop brought together forty-one people from twenty-four countries from all regions of the world and different sectors of society including informal sector experts and representatives from civil society such as business associations, think tanks, universities, labor unions, and human rights and pro-democracy groups. (See Appendix B for a participant list.) This paper was drafted to offer overview of the challenges that a growing informal sector poses to economic and political reform in emerging democracies in order to stimulate focused workshop discussions on the specific sources of and effective strategies for removing obstacles to formality. The lively exchanges between the participants in São Paulo yielded valuable insights on the reasons for informality and produced useful suggestions, strategies and policy initiatives on how to reduce these barriers. This feedback has been incorporated into this version of the paper.

This paper begins by defining the informal sector (section 2.0.) and discussing its size (section 3.0.). This is followed by a discussion of the political, social and economic

⁵ A recent study of 75 countries indicates that “the countries with more open access to political power, greater constraints on the executive, and greater political rights have fewer required procedures for entry regulation (of firms)—even controlling for per capita income—than do countries with less representative, less limited, and less free governments” (Djankov, La Porta, Lopez-de-Silanes, and Shleifer 2000:5).

implications of a large and growing informal sector (section 4.0.). In section 5.0., the different sources of high transaction costs exacerbating informality are reviewed. Section 6.0. proposes an action agenda with some recommendations on how to reduce transaction costs so that entrepreneurs have incentives to and can afford to join the formal sector. A reform strategy for the private sector is presented in section 7.0. In section 8.0., four specific policy initiatives formulated by participants during the São Paulo workshop are described. The paper concludes with the benefits of reducing barriers to participation (section 9.0.).

2.0. WHAT IS THE INFORMAL SECTOR?

The term informal sector originated from International Labour Organisation (ILO) reports on Ghana and Kenya at the beginning of the 1970s. According to these studies, the key problem in these two countries was not unemployment, but rather the vast number of working poor “struggling to produce goods and services without their activities being recognized”⁶ (ILO 1999:4). In general terms, the people working in the informal sector are independent, self-employed producers in urban areas some of whom employ family members and some of whom hire non-family workers or apprentices. Informal sector activities usually require little or no capital, provide low incomes and unstable employment and frequently operate amid unsafe working conditions.

Because the informal sector is heterogeneous in terms of its activities and occupations, studies use various terms, definitions and categorizations. Diverse terms used to describe this economy include: shadow, unofficial, third, underground, gray, hidden, counter, and parallel (see Thomas 1992:chapter 6.) The ‘traditional’ definition specifies the informal sector according to the size of businesses, the occupation of the worker and the type of technology employed (Cole and Fayissa 1991). This definition is now outdated because in today’s economy many formal sector businesses are small. Currently, there are two approaches to defining informal sector activity: the definitional and the behavioral (Farrell, Roman and Fleming 2000:389). According to the former, the informal sector is economic activity unrecorded in official statistics such as the gross national product (GNP), gross domestic product (GDP) and/or the national income accounts. The behavioral approach (sometimes referred to as the legalistic definition) is based on whether or not activity complies with the established judicial, regulatory, and institutional framework (Feige 1990:990; Portes et al. 1989:12; Loayza 1997:1; Saavedra and Chong 1999:99). This approach does not distinguish between activities that are extra-regulatory such as a food kiosk without a permit and those that are extra-legal or criminal such as drug trafficking.⁷

⁶ Thomas (1992) points out that these activities are referred to as the informal sector rather than the informal economy because they are not included in the official national income accounts.

⁷ Informal activities are further specified by classifying them into four categories: the criminal, the irregular, household and informal sector (see Thomas 1992). Criminal activities are illegally produced goods and services such as narcotics. The irregular sector consists of legally produced goods and services that are not legally reported and thus escape taxation. Household production includes goods produced in the household sector. The informal sector encompasses activities that circumvent the costs of complying with laws and regulations and thus are excluded from the benefits that stem from conformance with laws and regulations. Activities in all four categories could fall under the definitional or the behavioral

For the purposes of this paper, members of the informal sector are entrepreneurs who produce legitimate products without proper permits and legal status because they lack the resources and/or the incentives to comply with burdensome and excessive rules and regulations necessary to become part of the formal economy. As a result, they operate outside of the formal economy. Informal sector activities are extra-legal in the regulatory, and not the criminal sense.

Not only are informal sector entrepreneurs (“informals”) involved in diverse activities, but they skirt or comply with rules, regulations and laws to varying degrees. Becoming formal is a two-step process of 1) registering your business, and 2) complying with regulations (tax, labor and so on) thereafter. Entrepreneurs make calculated decisions as to which rules they will respect or violate based on what they can afford without having to go out of business, what they expect to receive in return, and the probable cost of non-compliance. So, for example, if obtaining a business license is rather easy, inexpensive, strictly monitored and offers access to government services, it is likely that most business will register.⁸ If complying with safety and/or accounting procedures is burdensome, seldom enforced and bestows few benefits, it is likely that entrepreneurs will not adhere to these rules.

In some cases, informality is not because entrepreneurs are unwilling to abide by laws and regulations, but rather because they lack the necessary resources to do so. In these circumstances, the cost of compliance precludes profit making and threatens entrepreneurs’ ability to make ends meet. Hence, many businesses have little choice but to operate informally. In other cases, the cost of complying with rules and regulations fails to outweigh the benefits. Thus, by operating informally, entrepreneurs can reduce costs without giving up much in return.

The informal sector is not a phenomenon found exclusively in transitional or developing economies, but is present in developed countries as well. In fact, informal sectors in many industrial countries increased during the economic recession and reorganization of the 1970s and 1980s and continue to exist today—such as the notorious sweatshops that flourish in New York (see Tanzi 1982 and Portes et al. 1989).

Distinguishing between the informal and formal sectors is not always easy. Often, entrepreneurs are involved in both sectors or there are linkages between the two sectors. In Nepal, for example, a large proportion of informal sector trade to India involves goods that entered Nepal legally (Taneja and Pohit 2000).

The characteristics and magnitude of informal sector activities vary within and between countries and regions. Following is a brief overview of some of the different

approach. The definition one uses is driven by the research question: the first definition is used to estimate the size and economic value of the informal activity, and the second definition is used to explain the causes of the informal sector.

⁸ When access to essential government services necessitated a business permit, registration increased (Lagos 1992).

characteristics of informal sector activity in the formerly centrally planned economies of Central and Eastern Europe (CEE) and the Former Soviet Union (FSU), in the developing countries of Latin America, and in developed economies such as Hong Kong, Italy and Spain.

In Central and Eastern Europe (CEE) and the Former Soviet Union (FSU), the informal sector is not limited to clandestine and sidewalk activities; many informal transactions are visibly conducted within large, state and privately owned firms.⁹ Often state officials and managers are associated with informal sector activity and use state assets or control access to these assets to operate more flexibly or to gain privately. Because of the dual nature of activities that are formal and informal (and because of the socialist legacy), these economic entities continue to enjoy state resources and the employees and managers continue to receive state social benefits. Although there is informal, criminal activity in the CEE and the FSU, the bulk of informality is extra-regulatory and shallow in nature. In other words, because informal sector activity is closely associated with state activities and is motivated by excess regulation, it often fluctuates between formality and informality rather than being deeply entrenched in the informal sector.

In Latin America, the majority of those in the informal sector are self-employed. Latin America has a tradition of burdensome and excessive regulations. Entrepreneurs of modest means reduce the cost of business by not complying with these regulations and by, instead, producing informally. In contrast to the CEE and the FSU, in Latin America informal activity tends not to thrive within state-owned enterprises. It is also less integrated with the formal sector than in Italy or Hong Kong.

In Hong Kong and in Italy, the informal sector is an important component of economic growth. Hong Kong's successful export-oriented economy has benefited from networks of small and informal producers who market their goods through specialized import-export houses. Although informals earn low wages, they enjoy significant free or low-cost public services. As a result, the informal sector in Hong Kong is not characterized by extreme poverty, vulnerability and exploitation as in other countries. Moreover, the dynamic export sector provides self-employment opportunities for informals (see Portes et al. 1989:302; Castells 1984; Sit, Wong, and Kiang 1979).

In the 1960s in Italy, a process of decentralization led to growth of the informal sector and an increase in total exports in the central provinces. Formal sector entrepreneurs sub-contracted the production of inputs to informals who operated according to a putting out system (see Portes et al., and Capecchi 1989). A similar process of decentralization occurred in Spain beginning in the 1970s with an accompanying surge in exports thanks to informal sector activity. The failure in Spain to take advantage of technological innovations led to a decrease in informal sector productivity and the persistence of sweatshop conditions within informal sector plants (Portes et al. 1989: 25).

⁹ This section is drawn from Kaufmann and Kaliberda (1996).

3.0. THE SIZE OF THE INFORMAL SECTOR

Scholars and practitioners generally agree that informal sector activity is expanding rapidly, especially in developing countries,¹⁰ but they disagree on how to measure the informal sector and on its actual size. Different measurement techniques yield huge size variances for the same country and time period.¹¹ Qualitative methods of data collection include participant observation, structured or semi-structured interviews, and typically use single firm data or surveys to obtain data.¹²

There are two quantitative measurement approaches: the indirect method and the model technique. The indirect method is based on measuring the discrepancies between expected levels of demand or receipts (such as electricity, currency, tax revenue, expenditures, employment, and transactions) and actual use of goods and services. These estimations use one indicator to measure the size of the informal sector; the multiple indicator multiple causes model (MIMIC) uses several. Each method, qualitative and quantitative, provides valuable information about the informal sector, but suffers from shortcomings that call into question their validity and reliability.¹³ This, coupled with the huge variance in results, has complicated developing general measurement techniques, testing hypotheses and generating theories about the causes of and solutions for informality.

According to Enste and Schneider (1998), approximately \$ 9 trillion went undetected from global GDP as a consequence of the informal sector. For emerging economies, this figure represents one-third of their economic output. The following tables illustrate the magnitude of the informal labor force:

Table 1. Informal labor force in urban areas (selected countries)

Country	Year	Percentage of total employment			
		Total		Men	Women
Bolivia	1996	57		53	62
Chile	1997	30		32	27
Colombia	1996	53		54	53
Côte d'Ivoire	1996	53		37	73
Ecuador	1997	40		39	42
Ethiopia	1996	33		19	53
Gambia	1993	72		66	83
Madagascar	1994	43		43	43

¹⁰ An exception to this tendency is Thomas (1992), who claims that diachronic size changes have, in fact, been minimal.

¹¹ This section is largely drawn from Farrell et al. (2000: 399-401).

¹² De Soto (1989) is considered to be best observational study to date.

¹³ For a comprehensive discussion of these different techniques, their results and their shortcomings, see Enste and Schneider (1998).

Mexico	1996	35		36	34
Peru	1996	51		50	52
Philippines	1995	17		16	19
South Africa	1995	17		11	26
United Rep. Of Tanzania	1995	67		60	85
Uganda	1993	84		68	81
Source: ILO (1999: 6-7).					

Average Size of the Shadow Economy for Developing, Transitional and Developed Countries as a percentage of GDP, 1990-93

Countries	1990-1993
<u>Developing Countries</u>	
Africa	
Nigeria and Egypt	68-76%
Tunisia and Morocco	39-45%
Central and South America	
Guatemala, Mexico, Peru and Panama	40-60%
Chile, Costa Rica, Venezuela, Brazil, Paraguay and Colombia	25-35%
Asia	
Thailand	70%
Philippines, Sri Lanka, Malaysia, and South Korea	38-50%
Hong Kong and Singapore	13%
<u>Transitional Countries</u>	
Former Soviet Union¹⁴	
Georgia, Azerbaijan, Ukraine and Belarus	28-43%
Russia, Lithuania, Latvia and Estonia	20-27%
Central Europe	
Hungary, Bulgaria and Poland	20-28%
Romania, Slovakia, and the Czech Republic	7-16%

¹⁴ According to Radio Free Europe/Radio Liberty (March 29, 2000), the amount of informal sector activity is estimated at one-third of GDP in Armenia and Georgia, one-fourth in Russia, Kazakhstan and Azerbaijan, and one-sixth in Moldova and Kyrgyzstan.

<u>Developed Countries</u>	
Greece, Italy, Spain, Portugal and Belgium	24-30%
Sweden, Norway, Denmark, Ireland, France, The Netherlands, Germany and Great Britain	13-23%
Japan, United States, Austria and Switzerland	8-10%

Source: Schneider and Enste (2000b).

4.0. IMPLICATIONS OF THE INFORMAL SECTOR

A growing informal sector is an indication that something is wrong -- existing laws and regulations are making transaction costs exorbitant. A large informal sector has serious consequences for private sector activity, economic growth and development, and the consolidation of democracy. These implications are relevant for policymakers, government officials, entrepreneurs and employees in the formal and informal sectors, trade unionists, and members of international and regional organizations. This section discusses the pernicious implications of high transaction costs and sizeable informal sectors and indicates why this should be of concern to every group in society.

4.1. Undemocratic Decision-making and Misguided Policies

Because members of the informal sector operate clandestinely, they have little opportunity to voice their concerns to government officials¹⁵ and thus policies are less responsive to their needs.¹⁶ Moreover, their lack of property rights fosters a concentration of economic power in the hands of a small number of elites who control government policymaking and large portions of economic activity through monopolies or oligarchies.¹⁷ This arrangement weakens check and balance mechanisms, potential opposition to the government, and government accountability vis à vis the general public thereby jeopardizing democracy (Louw 1996).¹⁸

Because informal sector activity is not included in official statistics, government policies and regulatory institutions that affect the entire population are made without data on a substantial amount of economic activity. This leads to misguided policy responses.

¹⁵ Brunetti, Kisunko and Weder's (1997) study indicates that businesses (formal and informal) often have little input into the policymaking process and would like to have more.

¹⁶ Historically, under such circumstances, if the institutional framework is not reformed, countries remained underdeveloped and prone to revolution (de Soto 1989).

¹⁷ Political systems with strong executives may compound this problem.

¹⁸ This is why property is protected in the US Constitution and in the article on eminent domain (see Reznik 1996).

For example, welfare programs to assist government-recorded unemployed who are working in the informal sector may be inflationary, and should be targeted to those who are even more marginalized and are in greater need of assistance than informals (Farrell et al. 2000:393). Moreover, the large flight of capital to the informal sector complicates macro-economic management.

4.2. Distorts Resource Allocation and Lowers Productivity

Entrepreneurs operate rationally within the set of institutional rules by using a combination of labor and capital to minimize production costs. If the legal and regulatory framework does not encourage an efficient use of resources then the economy is not achieving its potential on the production possibility frontier.

This can happen in many different ways. If the government demands exorbitant costs for business licenses, this benefits those with substantial financial resources who may not be efficient producers and harms those starting a new business with limited funds who may produce more efficiently. Similarly, if government officials enjoy a high degree of discretion in awarding business licenses, their friends or the rich may be granted licenses while others are not, thus preventing competition from new businesses and lowering overall economic productivity. Furthermore, costly labor regulations encourage formal businesses to use less labor and more capital than they might if labor regulations were less onerous and more flexible. Yet most developing economies have an abundant supply of labor and thus, with less stringent regulations could take advantage of this resource more efficiently. Conversely, informal sector production tends to be biased in the other direction overly relying on unskilled labor and failing to use more cost-effective capital. Moreover, if the formal property rights system is inaccessible to the general public because it requires complying with costly and cumbersome laws and regulations, many assets will remain outside the formal economy and will not attain their economic potential. Without formal, protected property rights, these assets can not be divided, combined and used in the most productive manner to generate additional value and increase productivity (for example, by creating limited liability companies or by pledging part of the assets as loan collateral). Each case is an example of a sub-optimal use of resources that could be improved by reforming legislation and regulations.

4.3. Erodes Competitiveness

Coase (1937) points out that the absence of well-designed, cost-efficient, stable institutions protecting property rights and contracts prompts businesses to minimize costs and risks by integrating vertically. This reduces firms' flexibility and mutes market signals. Moreover, the lack of these institutions hinders companies from decentralizing, specializing, subcontracting with competitive suppliers, offering reasonable insurance premiums, and attracting investment -- foreign and domestic. It also complicates the use sophisticated and creative asset combinations such as incorporated companies or flexible shareholding arrangements such as debt-equity swaps, or engaging in long-term investments and contracts essential for economies of scale. As a result, an economy will

not be equipped to compete globally and will run the risk of being excluded from global markets.¹⁹

High transaction costs also affect the degree of competitiveness of formal businesses vis à vis their informal counterparts. Those in the informal sector are not paying taxes or expending their resources to comply with government laws and regulations which, according to some, gives them an unfair competitive advantage over formal businesses.²⁰

4.4. Lack of Access To and Higher Costs For Essential Public Services

In many countries utility connections (water, electricity and telephone) require a legally recognized property title or lease as a form of securitization. Because most informals do not have property titles, they may be deprived of water, electricity and phone service. In some cases, informals have little choice but to tap electrical, water and telephone lines illegally, thereby raising the cost for regular subscribers. If there is widespread illegal usage, no private company will be willing to provide these services forcing the government to do so either at a high cost or at a loss (see de Soto 1996).

The illegality of informal entrepreneurs precludes them from using the court system to enforce contracts. The result is that they minimize risks by only engaging in short-term contracts with known partners involving small amounts of money. This limits their ability to expand and to benefit from economies of scale. In some cases, informals, deprived of access to the legal system, may resort to violence to enforce agreements or property rights.

4.5. Less Government Revenue for Public Services

Johnson et al. (1997) argue that countries with complex and costly taxation and regulatory schemes wind up in an economically unproductive equilibrium with a large informal sector. High taxes induce non-compliance, that is, informal businesses. This reduces government revenue and thus the amount of funds available to provide and maintain market-supporting, public sector goods and services such as the court system, government administration agencies, roads and so on. The fewer funds and the impossibility of preventing informals from using many of these services without paying for them diminishes their quality, increases prices, and leads to congestion. This, in turn, encourages even more entrepreneurs to leave the formal sector to avoid bearing an increasing share of the tax burden for poor goods and services.²¹ Moreover, quality and cost-efficient public services such as law and order and regulatory frameworks are

¹⁹ De Soto (1989), Pei (1995), Stone, Levy, and Paredes (1996), and Pistor (1999) each provide examples of how entrepreneurs were able to remain competitive by devising informal mechanisms of doing business when the legal and regulatory framework was ill-suited to their needs.

²⁰ Nonetheless, informal entrepreneurs do pay some taxes, such as value-added tax and they do incur other costs such as higher interest premiums that raise their operational costs.

²¹ A good equilibrium is one where tax revenues are used to provide quality public services that encourage participation in the formal sector and discourage informal sector activity (Johnson et al. 1997).

important production inputs. Their absence or weakness jeopardizes economic performance. In the end, countries become trapped in a vicious, unproductive cycle.

4.6. Lack of Information and Lack of Transparency Invite Corruption

Engaging in business requires information such as how to find suppliers and buyers, and the market value of goods and services being exchanged. Without inexpensive access to this information economic activity becomes very risky and costly.²² When deciding on whether or not to buy a company, for example, you need to know if the price accurately reflects a company's market value. If a company keeps accurate accounting records, figuring this out is straightforward; if a company does not, either you take the risk that the sellers are accurately representing the company's value or you expend the resources to go through the records and calculate the company's assets and liabilities. Regulations that fail to ensure transparency and accountability in privatization and procurement processes have been shown to invite corruption and to increase the cost of doing business (see Costa, Pedrone, and Fleischer 1998).²³

High transaction costs encourage corruption as well. Informal entrepreneurs may resort to corruption to avoid costly punishment for their illegality or to receive certain services like police protection of which they might otherwise be deprived. Studies using different measures have consistently shown that there is a positive correlation between the size of the informal sector and the degree of corruption (Enste and Schneider 1998:37; Johnson et al. 1997). Similarly, recent findings confirm that higher barriers of entry for firms are strongly associated with higher levels of corruption and larger informal sectors (Djankov et al. 2000:4). Corruption increases the costs of goods and services, lowers government revenue for essential services, distorts economic activity, and weakens the credibility of political institutions.

4.7. Weakens the Credibility of Political Institutions and Democracy

A sizeable informal sector indicates that a significant portion of the population is routinely not abiding by government laws and regulations and that the government is failing to enforce them. Again, this erodes the credibility of these institutions and of the government. Brunetti, Kisunko and Weder (1998) signal that a lack of credible rules discourages long-term investment and contracts thus economic opportunities are forgone lowering economic growth rates.

²² North (1992:62-63) emphasizes this point when he describes the sale of a piece of real estate, "Institutions determine how costly it is to make the exchange. The costs consist of the resources necessary to measure both the legal and physical attributes being exchanged, the costs of policing and enforcing the agreements, and an uncertainty discount reflecting the degree of imperfection in the measurement and enforcement of the terms of the exchange...Institutions in the aggregate define and determine the size of the discount, and the transaction costs that the buyer and seller incur reflect the institutional framework...It is worth emphasizing that the uncertainties...with regard to the security of rights are a critical distinction between relatively efficient markets of high income countries today and economies in the past as well as those in the Third World."

²³ A CIPE-sponsored study conducted by the Liberal Institute of Rio de Janeiro in 1996 found that opaque, unaccountable government procurement procedures greatly increase transaction costs (see Pezzullo 1999).

4.8. Wastes Resources and Hinders Growth

High transaction costs and a large informal sector squander economic potential and resources. To begin with, high barriers to obtaining property rights results in many entrepreneurs holding untitled assets -- what Hernando de Soto refers to as “dead capital”. De Soto (2000:35-36) estimates that the poor in the Third World and in former communist nations hold untitled real estate worth at least \$9.3 trillion. The capital is dead because the owners or users of these assets do not have access to the formal property rights system that would enable them to convert these assets into “productive economic currency” such as collateral for loans to start or expand a business.²⁴ Hence, informals are unable to borrow from formal credit institutions at reasonable rates denying them crucial resources. The lack of sound, accessible, legally protected property rights deprives informals of the possibility of dividing and selling part of their assets (in the form of shares for example) or recombining them to raise additional capital. Moreover, the lack of these rights robs them of the incentive to invest in their businesses by training personnel²⁵ or by purchasing capital such as computers or machinery necessary to undertake large-scale, long-term investment and thereby, to benefit from specialization and economies of scale.²⁶ Moreover, the impossibility of enforcing contracts prompts informals to contract only with known partners and/or to require advance payments (see Taneja and Pohit 2000).²⁷ As a result, informals tend to be stuck in low-growth undertakings. Loayza (1997:29) established that there is a negative correlation between the size of a country’s informal sector and the rate of national growth.

4.9. Increases and Reinforces Poverty and Inequality

Those who work in the informal sector tend to earn low incomes²⁸ because ill-designed institutions, particularly property rights regimes, discourage or prevent them

²⁴ Non-possessory pledge laws exacerbate this. As noted by Cadwell and Meagher (1996), prosperous economies depend on credit; the linchpin of a functioning credit system and a highly developed financial market is the non-possessory security interest. They point out that overall secured credit in the US is roughly \$1.8 trillion. Secured commercial bank lending and credit secured by moveable property has each been estimated at 40 percent. For the small business sector, secured lending is even more important—80 percent of the value of these loans is secured. Moreover, the ratio of cash to financial assets, which depends on reliable contracts and property rights, over time is a good measure of the quality of institutions necessary to encourage formal sector economic activity and to foster economic development.

²⁵ Saavedra and Chong (1999) and Tansel (2000) found that informal workers are less educated and receive less training than those in the formal sector. Similarly, Taneja and Pohit (2000) found that informal traders in Nepal and India have less education than their formal counterparts. Tansel (2000) also established that, in Turkey, female wage earners in the formal sector have significantly more education than their male counterparts, but that the reverse is true among wage-earning informals.

²⁶ A positive correlation has been established between secure property rights and investment (de Soto 1989; Gwartney and Lawson 1996).

²⁷ This serves as a barrier to new businesses, formal and informal, because their lack of an established, good reputation will make it difficult for them to enter into contracts with other businesses.

²⁸ The results of Saavedra and Chong (1999) indicate large wage differentials between formal and informal sector wage earners and smaller differences between the earnings of formal and informal self-employed workers.

from using their assets productively or from obtaining reasonably priced credit to expand their businesses; thus, they remain impoverished and unable to afford to become formal. Chong and Calderon (1998) analyzed the relationship between institutions, and inequality and poverty reduction. According to subjective indexes of institutional development, highly developed institutions tend to reduce poverty, despite an ambiguous relationship between institutions and inequality. Chong and Calderon (1998) suggest that the positive relationship between the development of formal institutions and inequality may be because in some developing countries, informal institutions predominate in the business transactions of the poor. As a result, the development of formal institutions benefits the formal sector more than the informal sector and thus does little to reduce inequality.²⁹ (This is particularly the case when informal sector entrepreneurs are prevented from participating in the policymaking process.) Moreover, because their activity escapes taxation, there is less revenue for the provision of social safety nets that could alleviate poverty and income inequality. All these factors contribute to and reinforce persistent informal sector activity and income inequality.³⁰

4.10. Weakens Trade Union Power and Erodes Workers' Benefits

Because of excessive and costly labor restrictions, employers hire fewer workers formally and hire more short-term workers informally. In fact, 80 percent of all new jobs created between 1990-94 in Latin America were in the informal sector. Urban informal employment absorbs 61 percent of the urban labor force in Africa, and is expected to generate more than 93 percent of all additional jobs in the region in the 1990s. The informal sector also absorbed between 40 and 50 percent of the urban labor force in pre-crisis Asia (ILO 1999).

The production structure of informal sector activity weakens the power and influence of trade unions.³¹ Informal sector activity tends to be heterogeneous and to occur in small production units, many of which are located in homes, forming loosely configured networks with multiple intermediaries between workers and capital. This complicates the organization and formation of trade unions within the informal sector. Moreover, members of formal sector trade unions now face competition from informal sector workers willing to work for lower wages and no benefits. These factors seriously weaken the bargaining power of trade unions vis à vis employers and their political

A study of the wage differentials between the formal and informal sectors along gender lines in Turkey reveals that wage-earning men in the formal sector earn more than their informal sector counterparts and twice as much as wage-earning, formal sector females; yet, informal sector wages for men and women are roughly equal (see Tansel 2000).

²⁹This hypothesis has not yet been tested and the results of the study are based purely on cross-country regressions, which do not tell us anything precise about the potential dynamic effects of institutional development over time (Burki and Perry et al. 1998:24:5). This may help explain why in poor countries institutional efficiency is positively linked with income inequality while for rich countries it is negatively linked with income equality.

³⁰A recent study by Rosser, Rosser, and Ahmed (2000) provides evidence of a correlation between the share of output produced by the informal sector and income inequality. Their study does not indicate the causes for this relationship, however.

³¹This section is based on Portes et al. (1989:31).

influence in the policymaking process. This has led to poor working conditions for informal workers who lack stable jobs, earn low wages and often work in unsafe and unhealthy working environments. For formal sector workers, these factors have contributed to a reversal of the historical conditions that enabled them to acquire legally protected rights and benefits including the right to form trade unions.

4.11. Inaccurate Contributions to International and Regional Organizations

The existence of informal sector economic activity that is not reported in official GNP statistics should be of concern to members of regional and international organizations such as the International Monetary Fund, the World Bank and the European Union, to name a few. In many of these organizations, GNP figures are used to determine a country's quota that, in turn, affects their voting rights, borrowing potential and terms of credit. Countries who wish to contribute less to regional or international organizations may have an incentive to misreport their GNP—this is facilitated by a sizeable informal sector (Tanzi 1999:340-1).

5.0. SOURCES OF HIGH TRANSACTION COSTS AND INFORMALITY

In many countries the size of the informal sector is large and growing. Research has shown that high transaction costs exacerbate informality. Institutions -- the rules and regulations that affect economic activities -- determine transaction costs, the incentives and disincentives of compliance, and the benefactors and losers of these arrangements. Often individuals or groups are interested in designing a system that benefits themselves and may not encourage overall economic growth (North 1992).³² Despite overwhelming evidence that such arrangements are unsustainable and unproductive in the long-term, history has illustrated that those who benefit from, have adapted to and/or have significantly invested in such a system have a vested interest and possibly the resources to maintain it for quite some time. The authoritarian polities and state-managed economies, and the crony capitalist systems of the post-World World II era are contemporary examples of this phenomenon. In such circumstances, vested interests whether legal entrepreneurs, rent seekers, economic oligarchs, or crony capitalists are likely to prevent or arrest reforms that would increase their business costs and risks and limit their benefits.³³ For this reason, poorly designed institutions enjoy extended life spans.

³² This has been the case for centuries. Absolutist regimes were designed to serve the aims of the monarchy. The institutional transition from absolutism to mercantilism was driven by monarchs' need for money; merchants were granted exclusive commercial domains protected through extensive state-backed regulations in return for revenue (see de Soto 1989 and Polanyi 1944). The result was a system of government-protected privileges for a small segment of society. Stigler (1971) refers to this practice as the theory of regulatory capture. See also Shleifer and Vishny (1993:601). Interestingly, stiffer entry barriers are not correlated with higher profit margins (Djankov et al. 2000).

³³ Employees of state-owned enterprises often resist reforms that would eliminate their jobs even though they and the economy as a whole would be better off in the long-term.

In these countries, institutions require businesses to comply with burdensome rules and regulations and fail to provide compliance incentives such as necessary, quality public services (such as infrastructure) at a reasonable cost. Hence, entrepreneurs of modest means without political influence simply do not have the resources to become and remain formal.³⁴ For these entrepreneurs, it is the impossibility of compliance, rather than the desire to disobey the law or gain a cost advantage over competitors, that drives them into the informal sector (de Soto 1989). For others, the benefits of compliance simply do not outweigh the costs.

Currently, many countries-- transitional, developing, and developed-- are grappling with the process of dismantling and reforming laws, rules and regulations that incur high transaction costs, benefit only certain segments of society, stunt overall growth, and encourage informality.³⁵

This section reviews the diverse perspectives on the sources of such costs. Often exorbitant costs originate from several laws, policies, and procedures that overlap or are closely linked. This complicates classifying these costs into clear-cut categories. In this paper, the diverse sources of transaction costs are grouped into the following rubrics:³⁶

- 1) the nominal cost of complying with laws and regulations
- 2) the degree of intensity, complexity and coherency of laws and regulations
- 3) access to necessary business-related information
- 4) the administration and enforcement of laws and regulations
- 5) the stability/predictability of laws and regulations
- 6) the quality of infrastructure
- 7) labor market structure
- 8) the degree of macro-economic stability
- 9) legacy of the former regime and cultural factors

These factors affect the two-step process of becoming formal: 1) registering a business, and 2) complying with regulations (tax, labor, etc.) thereafter.³⁷ Studies vary according to which factor(s) is (are) considered the main source(s) of transaction costs thereby prompting informality. Some approaches consider that one or more of the above

³⁴ Lagos (1992) points out that the step from informal to formal doubled operating costs in most cases.

³⁵ It is worth mentioning that not all transaction costs should be viewed negatively. Some transaction costs -- such as registering a business, buying a fire extinguisher and maintaining accurate bookkeeping records - - benefit entrepreneurs by giving them access to valuable public services, especially if compliance is inexpensive. If, however, following laws and regulations is unnecessarily expensive, does not encourage market-oriented economic activity, and does not provide entrepreneurs with quality, cost-effective benefits, then these rules and their accompanying costs are a problem. Also, see section 5.1.1. that points out that high taxation rates do not automatically stymie entrepreneurship and thus should not automatically be considered pernicious.

³⁶ There are some similarities between this categorization scheme and the chart in Enste and Schnieder (1998:53).

³⁷ There is some disagreement over which constitutes a more formidable barrier: the cost of becoming formal and or the cost of remaining formal (see de Soto 1989 and Stone et al. 1996). Undoubtedly, this differs according to country, region and sector.

nine causes prompt informality while others consider that specific issues within these categories (such as the level of taxation or employment benefits) exacerbate informality. Below is a review of the diverse approaches about transaction costs organized according to the nine categories above.

5.1. BURDEN OF NOMINAL COSTS

5.1.1. Taxation

Many scholars assert that high taxation rates³⁸ induce tax evasion and informality (Thomas 1992; Schneider 1994, 1997; Kaufmann and Kaliberda 1996; Johnson, Kaufmann and Zoido-Lobaton 1999; Tanzi 1999, among others). High taxes reduce profit margins and thus the incentive to engage in business in the formal sector or possibly at all (see Gwartney and Lawson 1996). The relationship between the rate of taxation and the size of the informal sector is complex, however. Johnson et al. (1999) found that the US has relatively high tax rates, but a small informal sector,³⁹ and that in some cases decreasing tax rates can lead to an increase in size of the informal sector. Moreover, different types of taxes and different taxation rates have varying impacts on a firm's tax burden and on the size of the informal sector. Their findings suggest that institutional aspects such as tax administration may affect the size of the informal sector at least as much as the tax rates.⁴⁰ (This will be discussed shortly.)

5.1.2. Employment Regulations

One perspective on why the informal sector is large and growing is that labor legislation is burdensome.⁴¹ According to Lagos (1992) complying with labor regulations is a substantial **fixed** burden for firms, unlike taxation rates, which may vary. Thus, the former is more onerous for lower income-earning firms.⁴²

³⁸ The different types of taxes include direct taxes such as income and corporate taxes measured by the average or marginal tax rates, and indirect taxes such as sales tax and tariffs. A large amount of informal sector trade from Nepal to India was found to be prompted by certain tariffs and non-tariff barriers (Taneja and Pohit 2000).

³⁹ This may be because the higher taxation rates are used to provide better quality public goods and thus encourage formality (Johnson et al. 1999).

⁴⁰ A recent study, (Djankov et al. 2000) found that tax-related procedures constituted less of a barrier to entry for new firms than basic administrative procedures necessary to obtain a registration certificate.

⁴¹ Tokman (1992) has linked this to the competitiveness of the global economy arguing that these pressures have led to reorganized, decentralized production processes and business strategies of contracting with the informal sector to avoid complying with costly trade union-stipulated employment conditions. New technology facilitates such arrangements.

⁴² Johnson et al. (1999) challenge this assertion. Their regression results indicate that the relationship between labor legislation and the unofficial economy is insignificant. They find taxation of factors of production, other than labor, may matter as much if not more. Similarly, Djankov et al., (2000) found that the labor-related firm entry barriers are not the most onerous.

To measure the extent of government-imposed restrictions on labor markets Rama (1995) developed an index and divided the results by per capita GDP to control for country differences in labor productivity. The eight index components are:

- the number of days of annual leave with pay
- the number of days of maternity leave
- social security contribution as a percentage of wages⁴³
- government employment as a percentage of labor force
- minimum wage as a percentage of the average wage
- severance pay
- the number of ILO conventions ratified, and
- the percentage of labor force in unions.

Rama calculated this index for 31 Latin American and Caribbean countries during 1980-1992 when labor regulations remained basically unchanged. Based on regressions using Rama's index results, Loayza (1997:24) found that there is a positive correlation between labor-market restrictions and the size of the informal sector. This may be because costly and restrictive labor codes tempt entrepreneurs to lower their operating costs and increase the flexibility of their labor supply by hiring informals.

5.1.3. Registering a Business

Registering a business legally can involve significant nominal costs. One of the first steps is to obtain legal title to assets whether it is a piece of land, an office building or a lease on a copyrighted manufacturing process. Securing legal title to property can be quite expensive for entrepreneurs of modest means. In the early 1980s, staff at the Institute for Liberty and Democracy in Lima, Peru calculated some of these costs (de Soto 1989:139-43). Their research indicated that a housing association whose members do not have the resources to buy an urbanized lot may request an adjudication of state land – a process that cost each member \$2,156 up front – an amount equivalent to minimum wage earnings of four years and eight months.⁴⁴

Lack of well-defined and secure property rights lowers the incentive to register property and hinders obtaining credit and converting assets into productive capital. Lenders need property as collateral otherwise they will not lend or will lend at very high rates. Moreover, the lack of clear and secure property rights makes non-possessory security laws unfeasible. As a result, entrepreneurs must physically deposit the few assets they have in order to obtain loans; this makes credit expensive. Lack of access to sufficient, reasonably priced credit prevents many from entering the formal economy.

⁴³ Schnieder (2000:417) indicates that OECD employers' social security contributions range from 8 percent to 32 percent of the annual gross earnings of an average income earner. Please note that the calculations originally come from Leebtritz, Thorton and Bibbee (1997).

⁴⁴ Zimmerman (2000) points out that the up-front, out-of-pocket costs required of South Africa's poor who wish to be eligible for the land redistribution program are, in fact, one of several barriers precluding eventual land ownership by the impoverished.

Formal registration also requires licenses and permits. This can be expensive as well. In Lima in 1983, setting up a fictitious garment factory with one worker cost \$1,231 – about 32 times the monthly minimum living wage; opening a small store legally cost \$590.56 – around 15 times the monthly minimum wage. In the mid 1990s, the process for a garment manufacturer to become formal in São Paulo, Brazil cost an average of \$640; in Santiago, Chile the same process cost an average of \$739 (Stone et al. 1996:105-6). In the spring of 2000, setting up an enterprise in Montenegro cost \$5,000 and 300 to 700 Dinars (Ivanovic et al. 2000). A recent cross-country study of 75 nations indicates that the official cost of setting up a firm is very high in most countries. At best, establishing a new business entails fees worth 1.4 percent of GDP per capita in Canada (US \$280), at worst 2.6 times GDP per capita in Bolivia (US\$2,696), and on average 34 percent GDP per capita (see Djankov et al. 2000).⁴⁵ Whether or not entrepreneurs register depends on whether or not they have the resources and the incentives (such as access to valuable public services or threat of costly punishment) to do so.

5.2. Intensity, Coherency and Complexity of Regulations

In addition to the nominal expense, becoming formal entails other costs stemming from complying with complex, at times incoherent, multi-step processes. Merely obtaining legal title to real estate can involve Herculean efforts to the tune of 168 bureaucratic steps involving 53 public and private agencies and taking 13 to 25 years in the Philippines; 77 bureaucratic procedures dealing with 31 public and private agencies taking 5 to 14 years in Egypt; and 111 bureaucratic hurdles and approximately 12 years in Haiti (de Soto 2000:20-1).⁴⁶

Registering a business can also be staggeringly complicated. Using the examples from above, in 1983 in Lima setting up a fictitious garment factory with one worker took 289 days and required 11 permits (de Soto 1989). In the mid 1990s, the process for a garment manufacturer to become formal in São Paulo, Brazil took an accountant around six weeks; and in Santiago, Chile the process took about two months (Stone et al. 1996:105-6). In the spring of 2000, setting up an enterprise in Montenegro required 38 steps and a minimum of 45 days (Ivanovic et al. 2000).⁴⁷ Djankov et al. (2000) show that in the best case scenario, establishing a new firm requires only 2 steps and 2 days in

⁴⁵ Interestingly, this study also found that the cost-to per-capita GDP ratio decreased consistently with GDP per capita and that countries with higher per capita GDPs have lower firm entry barriers (see p. 15).

⁴⁶ Moreover, lack of sound, accessible and secure property rights prevents entrepreneurs from using, dividing, recombining and exchanging their assets in the most productive way possible to generate addition value by, for example, establishing shareholder companies and issuing stocks, by pledging some assets as loan collateral or by using land titles to obtain telecommunication and electrical services. De Soto (2000) emphasizes that developed countries have been economically successful through capitalism because their property rights systems are designed to convert assets into capital by giving them a parallel life—for instance, a piece of land with a house on it can be a home and loan collateral simultaneously.

⁴⁷ It is worth emphasizing that the correlation between the number of steps and the time required is not linear. Often the cost of compliance is determined by the complexity of the steps and the degree of efficiency of government bureaucracy (Lagos 1992). The latter factor will be discussed shortly.

Canada, in the worst case scenario it takes up to 20 procedures and 82 business days in Bolivia, and on average it involves 10.17 steps and 63.05 business days.⁴⁸

Once a firm is actually registered, the costs to remain formal are often substantial because of ill-designed institutions characterized by duplicative and superfluous laws and regulations. This creates confusion among government officials and entrepreneurs who have to expend resources figuring out which laws and regulations apply. It also invites corruption and encourages informality. De Soto (1989:148) found that in Peru 21.7 percent of the costs of remaining formal were tax-related whereas 72.7 percent were linked to following administrative procedures.

Several authors, in addition to de Soto, have attempted to determine the cost of these regulations for formal businesses. Holden and Rajapatirana (1995) propose two measures: the amount spent on an external accountant to handle tax problems and the time spent by entrepreneurs and employees in dealing with the government. Similarly, Stone et al., (1996:107) looked at three types of regulatory costs for the garment manufacturing industries in Brazil and Chile: the usage and cost of external accountants; the proportion of proprietors' time spent complying with regulations; and the amount of employees' time devoted to tasks of compliance. It was found that significant resources were devoted to complying with government regulations.⁴⁹ Surveys of Brazilian entrepreneurs indicated that they must comply with over 50 sets of filing and payment requirements and with varying record-keeping demands. Moreover, it was found that a typical sale requires the filing of four or more copies of the sales forms (Stone et al. 1996:107).

Others have examined the relationship between the degree of administrative controls and the size of the informal sector. Such controls take many forms such as licenses, prices, exchange controls, interest rate controls, import and export quotas, to name but a few, and often differ from one sector to another.⁵⁰

⁴⁸ Please note that this study considers only the official time required to set up a business and does not include bureaucratic delays that may lengthen the process.

⁴⁹ Medium-sized Brazilian firms faced a higher regulatory threshold than small and large firms. Entrepreneurs responded by developing many small firms as opposed to expanding one firm (Stone et al. 1996).

⁵⁰ According to Lagos (1992), traders tend to be the least regulated because their activities require few changes to their business locale. Manufacturing locales are subjected to numerous health and safety regulations that often entail costly changes. Because most informal units, especially manufacturers operate in poor locales with old equipment, becoming formal is very costly. Some of these changes and requirements are essential to protect employees while others are superfluous and waste resources.

In the financial sector, unnecessarily high capital reserve requirements raise operating costs, for example, and lead to higher interest rates. Other financial market factors affecting transaction costs include the exchange rate policy, inflation and external dollar rate (see Holden and Rajapatirana 1995; Heritage Foundation 1997; Gwartney, Lawson and Block 1997).

Kaufmann (1994) constructed an index to measure the degree of administrative intervention⁵¹ in the economy and used this to identify the threshold at which entrepreneurs switch from the formal to the informal sector. He argues that inconsistencies between fiscal and monetary policies in Ukraine led to a proliferation of administrative controls over the economy, and prompting entrepreneurs to operate informally,⁵² ironically reducing the state's managerial control over economic activity.⁵³

Johnson et al. (1999) use several indexes measuring countries' annual regulatory burden⁵⁴ to assess their impact on the size of the informal sector. Although their results lost some significance after controlling for GDP variances, they established that overall regulations on firms appear to be more correlated with the size of the informal sector than are labor regulations.

In short, excessive, conflicting and complicated laws and regulations increase the costs of doing business, provoke informality⁵⁵ and invite corruption.⁵⁶ A startling example of how regulatory incoherence can incite corruption among government agents is how the Brazilian state and local safety codes indicate different heights at which fire extinguishers must be mounted. One businessman resolved the problem by having two sets of brackets per extinguisher and switching the location of the extinguishers according to which inspector -- state or municipal -- came to inspect. The inspectors then conspired to show up simultaneously so that at least one could cite a violation and thus extract a payment (Stone et al. 1996: 115:35).

5.3. Lack of Essential Business Information

Conducting businesses requires easy access to relevant information such as the requirements they need to comply with to get a business license and to operate legally. If institutions fail to provide this information at a reasonable cost (or at all), entrepreneurs may incur costs tracking down this information or may operate informally out of ignorance only to be fined for noncompliance later. An example of this is if credit agencies know which borrowers are creditworthy, they will be more willing to offer

⁵¹ The index is constructed by measuring the degree of administrative intervention in the foreign exchange, trade and pricing regimes. Each of these regimes is measured by two indices (see Kaufmann 1994: 52-8).

⁵² See also Kaufmann and Kaliberda (1996).

⁵³ Belarus and Uzbekistan have retained many Soviet-era administrative controls that are stifling economic growth and exacerbating informality. Hence, according to Radio Free Europe/Radio Liberty (March 29, 2000), "The worst of the economic transition may still await Belarus and Uzbekistan."

⁵⁴ World Economic Forum (1997); Heritage Foundation (1997); Messick (1996); Gwartney, Lawson and Block (1997).

⁵⁵ A recent survey of informal sector traders in Nepal and India indicated that operating informally was preferred because it entailed less paperwork, lower bribes, fewer procedural delays, and quicker payments and lower transaction costs overall than working in the formal sector (Taneja and Pohit 2000).

⁵⁶ A survey of informal traders in India and Nepal indicated that virtually all of them routinely paid bribes to enforcement agency officials and that complex, lengthy business procedures invited rent-seeking from government officials (Taneja and Pohit 2000).

potential borrowers loans at lower rates.⁵⁷ If they do not have this information, they will either spend the time and money to obtain it or, most likely, simply require larger amounts of collateral and charge higher interest rates, thus raising the cost of credit for businesses. It is worth mentioning that the way information is organized and stored also affects the cost. If businesses can access credit ratings on the phone or online quickly, it saves time and money that they may have wasted if they had to go look through files at an office across town or in a faraway city. If formal institutions fail to provide essential business information efficiently and inexpensively, entrepreneurs will have little incentive to pay the cost of becoming formal.

5.4. Administration and Enforcement of Laws and Regulations

Conducting business formally requires complying with certain laws and regulations. In order to comply, entrepreneurs must deal with government bureaucracies and courts. Several studies of the informal sector assess the importance of bureaucracies' and courts' performance in determining the size of the informal sector⁵⁸ (Loayza 1997; Johnson et al. 1999, among others). Two indicators are used to measure the quality of bureaucracy: its capacity to implement and enforce laws and regulations, and its autonomy from political pressure.⁵⁹

If government agencies and courts lack adequate financial and technical resources and skilled personnel, their capacity to administer and enforce laws quickly⁶⁰ and correctly is diminished-- even if laws are clear and coherent. If it takes 5 months to get a business license or to have a contract dispute adjudicated⁶¹ or if tax reimbursements were miscalculated, the costs are higher in terms of forgone opportunities. Entrepreneurs may choose to reduce such costs by not dealing with government bureaucracies and courts by operating informally.

The degree of transparency, accountability and political autonomy of government institutions and the extent of officials' discretion in implementing and enforcing laws are other important factors influencing the cost of doing business. In politicized, partial, and unaccountable administrative agencies and courts, personnel are prone to use their power to control the pace and the outcome of administrative procedures and enforcement processes.⁶² This situation invites bribery and corruption.

⁵⁷ Lack of regulation requiring regular and transparent disclosure of financial entities' assets increases risks and costs with potentially perilous results for a country's and the global economy. The Mexican, Asian and Russian crises are evidence of this.

⁵⁸ In Burki and Perry et al. (1998:18-9) there is a list of studies which have examined the relationship between institutions and economic growth, financial development, inequality, and poverty.

⁵⁹ These are two of five indicators from the International Country Risk Guide (ICRG).

⁶⁰ An oft-quoted phrase is "Justice delayed is justice denied!"

⁶¹ In 1995-96, CIPE sponsored a study conducted by the Liberal Institute of Rio de Janeiro that found that adjudicating labor disputes in Brazil was incredibly time-consuming and costly (CIPE, *Economic Reform Today*, 4, 1999).

⁶² Johnson et al. (1997) and Johnson et al. (1999) found that politicization of economic activity creates incentives for informality and may matter just as much as the nominal taxation rates. They note that politicization occurs when politicians and bureaucrats enjoy and exercise a high degree of discretion in

One of the most important government agencies is the judiciary. Without an impartial, transparent, efficient and credible judicial system business activity becomes very costly -- lengthy court proceedings deny justice and increase costs.⁶³ This encourages informality and weakens democracy and market-based transactions.

The extent of corruption also significantly affects the integrity and efficacy of bureaucracies and the cost of doing business.⁶⁴ Corruption within government agencies is measured by the degree to which government officials are likely to demand or expect special (illegal) payments.

5.5. Stability/Predictability of Laws and Regulations

When government agencies lack the capacity and incentive to administer and enforce laws and regulations adequately, consistently and impartially, legal and regulatory regimes become unstable and lose credibility.⁶⁵ Sometimes this unpredictability is exacerbated by frequent changes in the legal and regulatory framework.⁶⁶ This raises costs by forcing entrepreneurs to figure out which laws and regulations apply and to alter certain operating procedures, and instills reluctance to invest or to enter into long-term contracts.⁶⁷ As a result, businesses may lose the incentive to comply with laws and regulations.

Entrepreneurs may also lose motivation to comply with institutions if these do not correspond with their norms and values. If laws and regulations are made by a handful of policymakers or legislators without input from the public at large, it is likely that these rules will serve the interests of the former rather than the latter⁶⁸ and will be viewed as

creating and implementing rules and regulations pertaining to firms and resources. These include regulations governing privatized firms, entry and exit rules for businesses, businesses' use of land/real estate, tax collection, firm inspections and punishment for rule violations, international trade and foreign exchange transactions, and price setting. These mechanisms of control are used in CEE, the FSU, Latin America, and other regions.

⁶³ Fendt and Temporal found that lengthy labor court proceedings greatly increased transaction costs in Brazil (see project report by Pezzullo 1999). Buscaglia and Dakolias (1996) reached similar conclusions regarding general court cases in Argentina. It is worth emphasizing that speedy court decisions are not necessarily more just. See also Sachs and Pistor (1997).

⁶⁴ See Transparency International's Web site: www.transparency.org and Moody-Stuart (1996).

⁶⁵ The probability of being caught also influences an entrepreneur's decision to comply with laws and regulations. There tends to be more informality in trade and commerce because detection is more difficult.

⁶⁶ Brunetti, Kisunko, and Weder (1997;1998) found that the degree of credibility and reliability of rules is correlated with economic growth. These factors influence the size of the informal sector as well.

⁶⁷ The possibility of overturning property rights by decrees seriously undermines the stability of a property rights regime and thus, contracts deterring investment--foreign and domestic (Holden and Rajapatirana 1995).

⁶⁸ According to Chong and Calderon (1998) a potential explanation for the positive relationship between the development of formal institutions and inequality is that in some developing countries informal institutions tend to predominate in the business transaction of the poor. Hence it is possible that the development of formal institutions benefits the formal sector more than the informal sector. This is why it

illegitimate by society at large.⁶⁹ As a result, voluntary compliance will be low⁷⁰ and any government effort to enforce such laws and regulations will be enormously costly.⁷¹

5.6. Quality of Infrastructure

Commercial activity involves contacting buyers and sellers and transporting goods and services. How costly this will be depends on the quality and the level of technological sophistication of a country's infrastructure such as its telecommunication and transportation networks.⁷² If people have to travel long distances on unpaved roads or wait years to get a telephone line⁷³ business is costlier.⁷⁴ Not many entrepreneurs can afford this time thus they either do without the telephone or pay bribes to get one faster. Moreover, entrepreneurs will have little incentive to pay taxes or business-related fees to pay for services that are poor or non-existent. This induces entrepreneurs to leave the formal sector for the informal sector (Johnson et al. 1997).

5.7. Labor Market Structure

Another approach used to explain the existence and growth of the informal sector is the structure of the labor market. Historically, rural dwellers left for industrializing urban areas in search of better economic fortunes. The lack of formal sector jobs in cities forces newcomers to eke out a living informally. High unemployment rates continue to induce informality in many countries today by providing employers with a large pool of laborers willing to work informally for low wages and few benefits.

5.8. Macroeconomic Instability

A high degree of macro-economic instability creates greater incentives to operate informally. Macro-economic instability induces capital flight, foreign exchange purchases and barter. Moreover, it is easier to "doctor" accounts when prices are volatile and change rapidly (see Kaufmann and Kaliberda 1996:5).

is crucial that members of the informal sector participate in the policy making process. De Soto (1989) emphasizes this point.

⁶⁹ One of the components of the ICRG is the degree to which citizens' respect legal institutions.

⁷⁰ Pistor (1999) asserts that transplanted law—if it is not in accord with informal norms does not change entrepreneurs' behavior. Moreover, while laws and regulations can change overnight, behavior changes more slowly (see North 1992 and Pistor 1999).

⁷¹ North (1992) points out that in small markets where personal exchange occurs there is no need for costly specification and enforcement mechanisms. This is not the case in larger markets where exchange tends to be impersonal. Yet if laws and regulations are in sync with societal values and incorporated into their behavioral norms, enforcement costs will be lower in small and large communities.

⁷² Yoshino and Nakahigashi (2000) show that in developing countries there is a close relationship between infrastructure and economic development.

⁷³ In 1998, in the following countries, the waiting time to get a telephone line was longer than 10 years: Azerbaijan, Burundi, Ethiopia, Gambia, Guinea-Bissau, Haiti, Honduras, Lesotho, Malawi, Samoa, Sierra Leone, Sudan, Syria, and Zambia (ITU 1999).

⁷⁴ According to Taneja (1999), inadequate transit and transport systems in South Asia increase transportation costs and incite trade through informal channels.

5.9. Legacy of Former Regime and Cultural Factors

Even when institutions are reformed, entrepreneurs who for years operated informally may find it difficult to shed old habits.⁷⁵ Johnson et al. (1997) suggest that the length of time under communist regimes may explain the size of the informal sector in Central and Eastern Europe and the former Soviet Union.

Arguments about the long-lasting impact of cultural influences (see Taneja and Pohit 2000) and cognitive factors on entrepreneurs' behavior and perceptions are along the same lines. Undoubtedly, such norms and models strongly affect how individuals are likely to respond to various business-related constraints and opportunities and are unlikely to change overnight. Nonetheless, a well-designed reform strategy can positively influence these factors (see section 6.0.).

The bottom line is that entrepreneurs do a cost/benefit analysis of why they should or should not comply with regulations. Often, they comply with some regulations and not with others. Typically those in the informal sector fall on a continuum between formality and informality. Moreover, if institutions are weak and offer few or poor services or benefits, entrepreneurs have no incentive to abide by regulations or to pay for their operational costs.

6.0. ACTION AGENDA: A List of Recommendations

Section 5.0. presented the various sources of high transaction costs exacerbating informality. This gave us a general idea of what needs to be done to reduce barriers to participation. Overall, what is needed is a well-designed, clearly delineated, stable set of political and economic institutions that foster democracy and market-based economic activity and that level the playing field for all citizens.⁷⁶ This section takes this idea a step further and indicates a variety of ways to address these challenges with general and specific recommendations for particular issue-areas.

A preliminary list of suggestions was presented in an earlier draft of this paper. These were discussed and revised in a CIPE-sponsored workshop entitled "Barriers to Participation: the informal sector in emerging democracies" held on November 13, 2000 in São Paulo Brazil as part of the Second Global Assembly of the World Movement for Democracy (see www.wmd.org). The workshop brought together forty-one people from twenty-four countries worldwide, and from different sectors of society for the purpose of stimulating discussion about informality and devising effective strategies to remove

⁷⁵ Interestingly, in the Gosplan of the former Soviet Union, there was a line item for informal sector activity (although not referred to as such).

⁷⁶ It is worth emphasizing that the argument being put forth in this paper—that market and democratic-supporting institutions need to be established and maintained—differs from a neo-liberal approach which advocates for across the board deregulation, liberalization and privatization. Here the position is that markets need to be regulated, but that laws and regulations need to promote democratic governance and provide the right incentives for economic growth and prosperity.

obstacles to formality. Participants included informal sector experts and representatives from civil society such as business associations, think tanks, universities, labor unions, and human rights and pro-democracy groups. After the workshop discussions, the preliminary list of recommended actions was revised. Following is the updated list of general measures designed to reduce barriers to political and economic participation. (Specific policy initiatives developed in the workshop are described in section 8.0.) Naturally, each country or municipality should adopt and implement all or some of these suggestions according to the particular needs in each case. In other words, the ensuing list of recommendations is not a one-size-fits-all approach.

By way of introducing the recommendations, it is worth emphasizing that the success of these measures will be greatly enhanced by a sound and stable economic foundation. To this end, governments should institute fiscal discipline and a monetary policy geared towards low inflation in order to attain and maintain macroeconomic stability, and should limit the degree of intervention in the economy by pursuing liberal trade, exchange rate and interest rate policies, reducing barriers to foreign investment, privatizing state-owned enterprises and deregulating the economy (see Box 1). Moreover, if governments enact structural reforms and reduce onerous barriers to participation, the resulting economic growth will also benefit those who were already working in the formal sector thereby enhancing the benefits of becoming formal.

Box 1. MACROECONOMIC STABILITY: a precursor to economic reform and growth

Argentina

The most important lesson from the CIPE-sponsored Argentine program with the Mediterranean Foundation centers on the use of a structurally oriented shock approach to break an inflationary spiral. Stabilization, achieved through structural adjustment measures, served as a necessary element for the implementation of further structural reforms, such as trade liberalization and privatization, and for the establishment of an environment conducive to both foreign and domestic investment. By radically departing from previous plans through new monetary and fiscal regimes, the Cavallo Plan created positive changes and eliminated negative expectations.

Key Features of the Cavallo Plan, 1990-91

- Convertibility Law established peso/dollar parity and backed monetary base with dollars, gold and dollar-denominated government bonds
- Central Bank restricted from issuing new money to finance budget deficit
- Import tariffs lowered and simplified; quotas eliminated; bureaucratic procedures streamlined
- Cuts in government expenditures; series of revenue-raising measures, including increase in marginal value added tax
- Privatization of airline and telecommunications sectors; foreign participation actively solicited

Source: CIPE, *Economic Reform Today*, 3, 1992.

Encourage Participatory Policymaking and Lawmaking

Recent findings have confirmed that countries with representative governments (and checks and balances) have significantly fewer entry barriers for new firms (Djankov et al. 2000). Hence, transaction costs in the formal sector can be reduced by enhancing the degree of public participation in the policymaking and legislative processes by implementing measures proposed in the Sana'a Declaration (see Appendix A) and by the Institute for Liberty and Democracy in Peru.⁷⁷ This can be done in several ways:

1. by instituting transparent and inclusive decision-making procedures, involving all sectors of society -- including civil servants, the general public, labor organizations, business groups, informal sector entrepreneurs, and political parties -- in the design and implementation of reforms;
2. by implementing legislative procedures to ensure public access to plenary and committee meetings;
3. by holding public hearings on proposed legislation and regulations--complete with stated objectives and estimated costs of the laws in simple and straightforward terms--to receive public feedback, and by inviting citizens to send in comments; (It is particularly important to listen to the concerns of those in the informal sector because informality is often a response to ill-designed and poorly functioning formal institutions);
4. by establishing independent ombudsmen at the national and sub-national levels to represent citizens' interests to legislators and government officials; and
5. by empowering citizens to initiate legislation and referendums and challenge existing laws and policies (see Boxes 2 and 3).

⁷⁷ See <http://www.ild.org.pe> for examples of how some of these mechanisms were used to democratize policy and lawmaking and to reduce transaction costs in Peru.

Box 2. LEGISLATIVE ADVISORY PROGRAMS – AN ESSENTIAL REFORM TOOL

Legislative advisory programs are designed to analyze proposed legislation and regulations and provide simple cost/benefit assessments of their impact which are then distributed to legislators and the public at large. This contributes to more informed policy debates and offers the private sector an opportunity to shape government policies making them more responsive.

The Dominican Republic

The Center for Economic Orientation in the Dominican Republic launched a legislative advisory program in 1986 sponsored by CIPE. In concise reports, the Center analyzed economic laws under congressional consideration, summarized the effects of legislation on the public sector, private sector, national budget, and legal system, and concluded with specific recommendations – for enactment, repeal, rejection, or amendment of the bills under consideration. The reports were distributed among legislators and the general public timed to coincide with the congressional schedule. Through these reports, the Center was able to inform lawmakers, the media and the public of the consequences of the specific economic laws and regulations and provide information to the media and public interest groups to assist them in holding legislators accountable. The reports were widely used by business associations and the media.

Argentina

In Argentina, the effort is managed by the Institute for Economic Research of Argentina and Latin America (IEERAL) of the Mediterranean Foundation supported by Argentine business executives. The Argentine project is distinct because reports are done on the national and provincial levels because local legislative assemblies are autonomous.

Legislative experts produce three reports per month which are published in the Foundation's magazine, *Novedades Económicas*, and sent to national and provincial legislators, government officials, business and professional organizations, and the media. The Foundation organizes monthly meetings where members of the private sector can comment on the analyses to ensure that the reports reflect their concerns. Moreover, IEERAL staff is available for consultation to all legislators, regardless of political affiliation.

Legislators have hailed the reports as "efficient mechanisms for an inefficient parliament," because they are systematic and focus the legislative debate on the most important technical elements, making it easier for legislators to make informed decisions. Journalists have praised the reports for providing them with essential information on legislative proceedings.

According to IEERAL's quarterly scorecards, about 60 percent of IEERAL's suggestions were incorporated into final legislation. For example, IEERAL suggested that the legal framework regulating the national airline, *Aerolíneas Argentinas*, and the various bills for its privatization be amended to preclude the formation of a private monopoly hindering competition. The Congress heeded one of IEERAL's requests and deregulated charter flights. (Continued on next page...)

Legislative Advisory Programs Worldwide

The Dominican Republic's legislative advisory service was a trailblazing initiative that has served as a model for similar legislative advisory services worldwide. In the Western Hemisphere, such efforts are underway in Argentina, Brazil, Central America, Chile, Ecuador, El Salvador, Guatemala, Paraguay, Peru and Uruguay. In Central and Eastern Europe, organizations in former Czechoslovakia, Hungary and Poland are building legislative advisory services. A Sri Lankan organization is the first to launch a similar project in Asia. Each effort is, of course, tailored to the legislative context in each country. As a tool for lobbying and informing politicians, however, the basics remain the same.

Key Features of Successful Legislative Advisory Programs

The following features can increase the effectiveness of a legislative advisory program:

- **Credibility.** Each legislative advisory program should be based on sound economic analysis, and background papers should be readily available for technocrats and others to study and critique.
- **Simplicity.** Summaries should be written in clear language and stated in terms of the country's general interests, as opposed to the interests of one particular group, such as business or labor.
- **Availability.** Summaries should be printed and disseminated to a broad audience. Where possible, arrangements should be made with the media in order to provide even wider coverage.
- **Policy dialogue with government officials.** In many countries, bureaucracies represent formidable obstacles to reform. In their attempt to affect public policy, business organizations should try to influence government personnel, as well as legislators.

Sources: Wallack (1991) and Sullivan (1999).

Box 3. LEGAL AND REGULATORY REFORM IN HUNGARY, 1989-1994

In the late 1980s and early 1990s, with funding from the National Endowment for Democracy and the U.S. Agency for International Development, CIPE initiated the Legal and Regulatory Reform in Hungary (LRRH) project with six Hungarian partner organizations. Initially, the reform effort concentrated on the financial sector, the informal sector, the real estate market, privatization, tax policies, local government's role in private sector development, and the impact of public opinion on reform. The major objectives of the LRRH project included:

- Promoting a reform program based on sound research and Hungary's principal economic policy requirements;
- Developing advocacy skills of and encouraging cooperation among independent business organizations and public policy groups in order to promote legal and regulatory reforms effectively; and
- Accelerating the pace of reforms through a coordinated, locally led advocacy effort.

CIPE's Budapest office brought together disparate analysts and policymakers regularly and developed and reinforced advocacy techniques forming a solid pro-reform policy community. In 1994, CIPE and its Hungarian partners produced a groundbreaking report, *Crossed Paths: Straightening the Road to Private Sector Growth*. The report served as a "road map" for Hungary's leading decision-makers in the public and private sectors looking to achieve meaningful economic reform. Today, six years after the report was issued, nearly two-thirds of the report's 41 recommendations have been adopted by the Government of Hungary. One of the success stories is the enactment and implementation of pension reform laws. Equally important, all of the reforms have proved to be successful and sustainable over time.

Source: Marer and Gelenyi (1999); see <http://www.cipe.org/prog/evaluations/hungary/>

Enact and enforce freedom of information laws

Adopt and enforce freedom of information laws that mandate that the public has access to committee documents and government laws and regulations (draft and enacted), budgetary information, and legislators' voting records so that citizens and the media can assess public officials' records and then hold them accountable.

Streamline Legal Codes

Laws and regulations should be clarified so that rights are clearly defined, rules are clearly specified, and administrative and enforcement procedures are straightforward so that the possibility of multiple interpretations and applications of laws and regulations is minimized. To this end, duplicative, superfluous, complex and conflicting laws and regulations should be rescinded⁷⁸ and steps necessary to comply with the law should be streamlined⁷⁹ (see Box 4).

⁷⁸ CIPE is currently sponsoring a project in Ecuador managed by the National Association of Entrepreneurs to do just that (see www.cipe.org).

⁷⁹ The Institute for Liberty and Democracy in Peru spearheaded a movement that culminated in the adoption of the Administrative Simplification Law in 1989. This law eliminated bureaucratic red tape, streamlined public administration and reduced transaction costs (see www.ild.org.pe for more details). See

It is worth mentioning the relationship between changing legal and regulatory codes and altering entrepreneurs' behavior. The former can and often do change swiftly while the latter tend to transform slowly. Yet, if laws and regulations are consistently enforced and benefit the general public, they will begin to shape new business-related practices over time. In other words, a viable short-term strategy to improve the business climate should begin with ensuring that the appropriate legal and regulatory codes are in place and regularly enforced. Cultural norms and cognitive models then will gradually adapt and reinforce these new frameworks.

also the CIPE-sponsored project in Montenegro designed to streamline the requirements for obtaining a business license (Ivanovic et al. 2000).

Box 4. ARMENIA STREAMLINES LAWS AND REGULATIONS

In Armenia, CIPE is currently sponsoring a program designed to mobilize the business community to advocate for reforms that will improve the business climate. To this end, quarterly roundtables are held between members of parliament and other government officials, and businessmen. These efforts have successfully clarified and streamlined laws in two areas -- inspections and taxes -- thereby reducing transaction costs and opportunities for corruption.

Previously, Armenian entrepreneurs were plagued by frequent, arbitrary inspections from an overwhelming number of government agencies whose employees often conducted inspections in order to extract payoffs, and by complicated tax laws.

New Law on Inspections of Private Businesses

On May 17, 2000 President Kocharian signed a new law (no. 010.0060) on inspections. The law regulates the government bodies that can inspect commercial and non-commercial businesses. The major features of the law are:

- Only 19 specific governmental agencies are authorized to perform inspections.
- The law regulates the subject matter, timing, and reason for inspections.
- It specifies the governmental agencies that can make secondary inspections.
- In the majority of cases, with the exception of criminal issues, the inspection agencies are authorized to conduct only one inspection of a business per year.
- The private business has the right to invite its own experts (such as attorneys, auditors, accountants, and so on) to the inspection.
- The government must set up a coordination system and a plan for inspections.
- The inspection agency must give the business 3 days notice and clearly indicate the goals and objectives of the inspection.

New Law Simplifies Tax Procedures

On June 5, 2000, the Armenian Parliament adopted a simplified tax law that became effective on July 1, 2000. The law regulates accounting principles of small and medium enterprises and allows private entrepreneurs to use a simplified accounting system on a voluntary basis. The simplified system replaces the value-added tax (VAT) and profit tax for legal entities and the VAT and income tax for private entrepreneurs. Private entrepreneurs or legal entities whose total turnover of goods and services during the previous year does not exceed 30 million Dram, excluding VAT (approximately US \$55,000), can apply to use the new system at local branches of the tax inspection office.

Source: www.cipe.org.

Private rights regimes should be reformed and strengthened so that assets can serve as an engine of growth and productivity.⁸⁰ Property rights are the legal vehicle through which assets are converted into productive capital. In short, property-related laws and regulations should be designed so that the economically and socially useful aspects of assets are described and recorded in a logical, cost-effective, standardized manner. Take the example of a piece of land. Relevant information about the land would include its size, location, perimeters, topography, approximate market value, its owner(s), whether or not the title has been paid in full, whether or not the owner has exclusive title rights, whether or not the land has been pledged as loan collateral, whether or not the title secure, and so forth. Almost no one would be willing to buy this land without this information. How can a business expand if it cannot buy more land or new office space? In sum, property rights systems need to provide such information so that assets, such as land, can be bought, sold and leased securely for productive purposes.

Yet providing and acquiring this information incurs costs. These costs can be minimized in two ways. First, by streamlining property rights systems by eliminating duplicative and superfluous laws and regulations and unnecessarily cumbersome procedures. Second, by establishing simple and straightforward standards to specify clearly who owns what and how these rights can be combined or exchanged (for example, through commercial transactions),⁸¹ and for recording required information in a timely and cost-efficient manner into an integrated, publicly accessible data base.⁸²

Last, but not least, these laws and regulations need to be strongly and consistently enforced by an effective and impartial legal system so that the property rights are secure.

These measures will make it possible and provide the incentives for the person of modest means to acquire legal title to their assets and to begin using their assets in the markets of the formal economy. In other words, these reforms would encourage and facilitate asset holders to exchange their property with unfamiliar entrepreneurs located faraway as opposed to only with neighbors who can physically examine the property and who know its owners. Moreover, these steps will greatly stimulate growth by providing entrepreneurs with a uniform, inexpensive means of evaluating, dividing, combining and exchanging assets so that they can use them in the most productive way possible to create additional capital and to take advantage of business opportunities.

Supervise the Financial Sector

⁸⁰ This section is largely drawn from de Soto (2000).

⁸¹ It is crucial that the laws and regulations correspond with the general public's understanding of and consensus on how assets should be held, used and exchanged. For more specific steps on how this can be accomplished see de Soto (2000:160).

⁸² One of CIPE's first grants was to the Institute of Liberty and Democracy (ILD) in Peru to create a streamlined property registry system. This led to a dramatic increase in the number of properties registered in Peru. The ILD team is currently doing similar work in the Philippines, Haiti and Egypt (see De Soto 2000).

Devise and routinely implement appropriate prudential supervision mechanisms for banks and financial entities. This will minimize systemic risks in the financial sector including those related to moral hazard that can drain enormous resources from a country and destroy the business climate (see Box 5).

Box 5. WEAK FINANCIAL REGULATION UNDERMINED CHILEAN PRIVATIZATION

A telling example of the importance of effective regulatory frameworks is the initial, unsuccessful privatization experience in Chile in the mid-1970s to early 1980s. At that time, Chilean business conglomerates purchased banks with as little as a 20 percent down payment. These same business groups used loans from these banks to buy non-financial firms with down payments of only 10 to 40 percent. Hence, highly leveraged purchases concentrated financial and industrial power in the hands of a few conglomerates. The Chilean supervisory system was weak, understaffed and ineffective and thus was ill-equipped to prevent insider lending such as this. In 1982, Chile experienced an economic crisis generated by an overvalued currency, domestic economic difficulties and external shocks. Business groups responded to the crisis by using their banks to shore up firms in trouble, that in turn aggravated the financial problems of the firms and the banks. In the end, the Chilean government re-nationalized a slate of firms and banks. The Chileans learned from this experience, however. Afterwards, they strengthened the supervisory system, recapitalized the banks, and then re-privatized the banks and firms. The second time, the appropriate regulatory framework precluded connected lending and put limits on the leverage of bank capital. Today, the Chileans enjoy a diversified, well-functioning financial system and a booming private industrial sector. From Galal and Shirley (1995:93).

Institute Corporate Governance

Institute corporate governance by developing legislation that protects investors, shareholders and stakeholders, supporting transparent shareholder registries, adopting and implementing the Organisation for Economic Cooperation and Development's (OECD) Convention on Corporate Governance, and adopting and complying with International Accounting Standards (Sullivan 2000)⁸³ (see Box 6).

⁸³ See www.cipe.org/efn/governance.php3 for a wealth of information about corporate governance.

Box 6. CORPORATE GOVERNANCE INITIATIVE FOR ECONOMIC DEMOCRACY: A CIPE-SPONSORED PROJECT BY THE INTERNATIONAL CENTER FOR ENTREPRENEURIAL STUDIES (ICES), BUCHAREST

With the goals of promoting investor confidence, bettering the country's business environment and reducing corruption, ICES together with the Strategic Alliance of Business Associations (SABA) developed a "Voluntary Code of Corporate Governance" for the Romanian business community. Having received both local and international attention (an English translation has been distributed in Europe and the U.S.), this code of best practices is proving to be a decisive advocacy tool. A series of 10 local roundtables led to the creation of the "Blueprint for Action" strategy for developing corporate governance in Romania. The feedback and contributions of the business community at several workshops served to establish a national network on corporate governance and have driven advocacy efforts at all levels in Romania.

Source: www.cipe.org/prog/partner/ices.php3

Combat Corruption

Implement effective anti-corruption measures by specifying and streamlining legal and regulatory codes, clarifying laws on conflict of interest, adopting and implementing Transparency International's Government Procurement Code, and adopting and adhering to the OECD's Anti-Bribery Convention (Sullivan 2000).⁸⁴

Reform Government Agencies

Government agencies that are excessively bureaucratic and inefficient need to be reformed. This can be accomplished by streamlining and simplifying agencies' internal operating procedures and by regularly evaluating agencies' performance according to clear, well-defined standards. Measures to improve poorly performing agencies need to be implemented promptly and comprehensively. By way of example, when exported and imported goods are held up for lengthy periods of time in government-owned ports entrepreneurs' costs increase and the competitiveness of these goods decreases; moreover, the temptation to ask for and pay bribes to speed up the process increases.

Match Laws and Regulations with Institutional Capacity

Realistically assess each government agency's functional capacity and tailor laws and regulations accordingly. In other words, if a country wishes to adopt another nation's property rights system, it is recommended that they do so only if their institutions have the necessary capacity (financial, human and technical) to implement and enforce it

⁸⁴ For a whole host of articles and links about reducing corruption, please see CIPE's Web site: www.cipe.org. See also the Final Report on the Washington Conference on Corruption, "Fighting Corruption in Developing Countries and Emerging Economies: the role of the private sector," sponsored by USAID, PriceWaterhouseCoopers, and CIPE, February 1999.

effectively. Without such capacity, property rights will not be protected and transaction costs will remain high.

Match Laws and Regulations with Entrepreneurs' Capacity to Comply

When legal and regulatory codes are reformed or enacted, the capacity of entrepreneurs to comply should be kept in mind especially if the changes involve substantial costs initially. If entrepreneurs lack the resources, they will not be able adhere to the new rules no matter how well-designed they are. In these cases, granting a transition period during which entrepreneurs can adjust to new codes is likely to increase compliance and thus formality in the long-term.

Strengthen Administrative and Enforcement Capacity of Government Agencies

Strengthen and maintain government agencies' administrative and enforcement capacity by cultivating a staff of well-qualified civil servants, hiring and promoting staff based on verifiable professional standards (through standardized tests), offering civil servants vocational training based on the latest technology, paying adequate salaries to attract well-qualified professions and to deter bribe taking, and offering tenure based on performance (not on the election cycle). The capacity of government agencies can also be bolstered by providing sufficient financial and technical resources to administer laws expediently.⁸⁵ New ways to reduce the costs of and improve the effectiveness of administering and enforcing laws and regulations, and to encourage market efficiency should be tried (North 1992).

The judiciary should be reformed and strengthened so that it enforces laws consistently, efficiently and fairly thereby maintaining the rule of law.⁸⁶ In addition to the suggestions in the preceding paragraph, alternative means to resolve disputes out of court through arbitration is one way to lighten the courts' load and expedite conflict resolution. In countries where commerce is regulated by civil codes not bound by precedent (including many in Latin America), laws and regulations can be overturned by decree greatly weakening stability.⁸⁷ Some scholars suggest that greater horizontal accountability or checks and balances be instituted to minimise frequent, radical changes to the legal and regulatory framework and general abuses of governmental power (Schedler, Diamond, and Plattner 1999).

Reform Taxation Systems

Taxation systems should be reformed by lowering the overall tax rate, targeting corporate and income taxes rather than international trade taxes (such as tariffs), revising tax codes so that they are simple and straightforward by eliminating multi-step, complex

⁸⁵ Using cutting-edge technology can greatly reduce operating costs in the long-term.

⁸⁶ For a comprehensive overview of the challenges involved in creating an impartial and independent judiciary, see Domingo (1999).

⁸⁷ Moreover, governments in civil law countries exhibit a greater tendency to intervene in the economy and to erect high barriers to entry for new firms (see Djankov et al. 2000).

procedures on fiscal reporting, strengthening consistent enforcement of taxation laws by increasing administrative capacity and minimising officials' discretionary powers.⁸⁸ These measures can increase revenues by broadening the taxation base in the long-term. Higher revenues can be channelled into better quality public services⁸⁹ (see Box 4).

Reform Labor Regulations

Reform labor codes by eliminating outdated legislation, allowing for more flexible work contracts such as part-time or short-term employment or contract-based arrangements, extending the trial period for new employees, allowing employers and employees to negotiate salaries independently of the government and privatizing pension funds. Moreover, the right to associate freely should be vigorously protected. In other words, individuals in any industry or sector should have the right to choose whether or not they wish to join a trade or labor union based on what they believe they will gain in return. This choice is eliminated either by closed shop provisions or by restrictions on the right to organize. Neither of these two extremes offers citizens the right to associate freely (which means the right to join and the right not to join) that is an essential component of democracy.

Streamline Business Permit Requirements and Costs

Facilitate obtaining a business permit or license by lowering the nominal cost of obtaining a business license or permit and ensuring that requirements to acquire a permit or license are simple, straightforward, well-publicized and accessible to the entrepreneur of modest means; a one-stop process that can be completed in different cities throughout a country would greatly reduce costs (see Ivanovic et al. 2000 and de Soto 1989).⁹⁰ Legally mandate that once these requirements are fulfilled permits and licenses are granted immediately and automatically and registered in a centralized business registry for public record.

Provide essential business information and training

Provide essential business information and training concerning how to obtain a license or permit, how to start a new business, how to form various legal commercial entities such as joint ventures, incorporated companies and so forth, how to invest, and how to understand and comply with business-related laws and regulations (see Box 7). With adequate funding, these services can be offered on the national and municipal

⁸⁸ In Bolivia when the tax system was reformed, the rate of registration for micro-enterprises reached 90 percent (Lagos 1992:95:7).

⁸⁹ It is important to note that the relationship between high taxes and quality public service is not linear. In other words, more taxes do not automatically translate into better services. Public funds must be used judiciously so that the right institutions are established and function efficiently. A study of judicial reform showed that more money for the judicial branch did not lead to a more impartial and efficient judiciary (Buscaglia and Dakolias 1996).

⁹⁰ In Hungary, when the government made the cost of registering a business tax deductible, the size of the informal sector decreased (see Kallay 2000).

levels. (Such endeavors must be undertaken in conjunction with efforts to reform key political and economic institutions—otherwise these programs will merely subsidize an ill-designed system.)

Box 7. THE CENTER FOR ENTREPRENEURSHIP IN MONTENEGRO PROVIDES ESSENTIAL BUSINESS INFORMATION AND SERVICES

To support further private sector development in Montenegro, leading economists at the University of Podgorica have established the Center for Entrepreneurship (CFE), an independent non-governmental organization dedicated to supporting economic reform, privatization, and entrepreneurship. CFE staff identified one of the main barriers to private sector development -- the lack of business support services and entrepreneurship training. Seeking to address this shortfall, CFE has established its “Business Center”, a business service center to provide counseling to new businesses and offer entrepreneurship training programs. Recognizing the wide range of training needs, CFE has targeted training to the unemployed seeking basic information on starting a business, and to existing businesses seeking to expand through partnerships, joint ventures, and new investment. While the Business Center has officially begun operation (training over 100 entrepreneurs, with 10 new businesses begun), it has done so with little financial and technical support. CFE staff is working to improve service delivery and define the organization’s structure, strategy, and sustainability.

Over the next several years CFE and CIPE will work to expand the network of offices and range of services, to produce a Montenegrin-wide network of business centers providing consulting, training and other services to the private sector. In addition, a number of important new projects will also be implemented during this grant period that will allow the CFE to target specific sectors of the population more effectively as well as to increase the involvement of Montenegro’s fledgling private sector in the policy process. The project has already successfully assisted several small businesses to set up shop or to expand production and trade, increase efficiency, and create new jobs.

Source: www.cipe.org.

Improve Infrastructure

Improve the efficiency, cost-effectiveness, and quality of infrastructure essential for a market system by ensuring a fair amount of competition in these domains through privatization or transparent subcontracting bids with the government.

Reform Pledge Laws

Reduce the cost of credit by enacting laws that permit the pledging of moveable assets as collateral and non-possessory securitization, developing a centralized, up-to-

date information system indicating to whom and over which time period assets have been pledged, and ensuring that bankruptcy laws protect creditors claims and that debt is not favored over equity.

The Role of the Corporation in Society

Encourage businesses to adopt and implement the Global Sullivan Principles (see Appendix C for the full text) designed to foster economic, social and political justice; protect human rights; encourage equal opportunity at all levels of employment, including racial and gender diversity on decision-making committees and boards; train disadvantaged workers for technical, supervisory and management opportunities; assist with greater tolerance and understanding among peoples thereby helping to improve the quality of life for all.⁹¹

7.0. REFORM STRATEGY FOR THE PRIVATE SECTOR

High transaction costs and informality persist because reducing barriers is expensive. For an individual, operating within the current system is less costly than expending the resources to change it. For entrepreneurs or conglomerates that have adapted to and/or benefit from the existing system, resisting change is often less costly than adjusting to a new system. This is where think tanks and business associations can play a role by either reducing the per capita cost of promoting reform or by providing incentives for change. The following is a series of steps indicating how the private sector can design and garner support for some of the previously mentioned reforms geared towards reducing transaction costs, leveling the playing field for all entrepreneurs, and encouraging formality.⁹²

- Pro-reform private sector associations and think tanks need to collaborate and conduct research to identify the sources of transaction costs⁹³—these could stem from the existence or the lack of specific laws and regulations—and to calculate the economic impact of each relevant law and regulation.⁹⁴

⁹¹ Based on the preamble of the Global Sullivan Principles (see Appendix B). See also Kanaga (1999).

⁹² The National Confederation of Industries in Brazil, led by Jose Augusto Fernandes, is in the process of carrying out such a project entitled “Brazil Cost.” A description of this effort and its results will be published shortly by CIPE.

⁹³ With a USAID grant, staff in CIPE’s Montenegro office are working with members of the Center for Entrepreneurship in Montenegro to conduct a survey of approximately 500 enterprises in order to learn more about their characteristics and the barriers to business that they face. Based on the results, projects can be designed to reduce these specific obstacles and improve the business climate.

⁹⁴ Stone et al. (1996) suggest that any assessment of which institutions need to be reformed first should be based on an examination of all institutions, formal and informal, to ascertain the true effect of ill-designed laws and regulations. They point out that in Brazil certain informal institutions replace government laws and regulations and effectively reduce transaction costs. As a result, they argue, these institutions should not be short-term reform priorities, but long-term ones. Similarly, Taneja and Pohit (2000) found that informal sector traders in India and Nepal devised efficient institutional arrangements that facilitated trade and mitigated risk.

- Pro-reform private sector associations and think tanks need to work with experts to evaluate draft laws and regulations and to propose new ones that would reduce transaction costs and barriers to formality.
- Publish the results in an accessible format such as the US Chamber of Commerce's National Business Agenda booklet that, on one page, presents a law or policy in question, indicates its importance including the estimated cost, and suggests a position (that is, whether or not the law or regulation should be supported).
- Disseminate the booklet to the public via the media and Internet specifically targeting groups (including policy and lawmakers) likely to be supportive of such reforms and ask for their feedback.⁹⁵
- Host public debates and forums to raise awareness about and discuss suggested reforms, to network, and to form alliances and a consensus among reform-oriented civil society groups so that a pro-reform constituency is established.
- Institute regular meetings between representatives of civil society and legislators and policymakers as a mechanism for the public to voice its concerns and shape reforms.
- Members of the private sector should use their networks and alliances to encourage reform-oriented citizens to contact relevant policy and lawmakers and urge them to support proposed reforms.

(For information about and examples of national business agendas, please see Box 8.)

⁹⁵ Over the course of several years, CIPE has sponsored highly successful legislative advisory services in many regions of the world where market-oriented think tanks studied the impact of draft laws and presented the results to legislators so that they could make informed decisions. See Boxes 1- 8.

Box 8. HOW BUSINESSES CAN AFFECT PUBLIC POLICY BY DEVELOPING A NATIONAL BUSINESS AGENDA

Several CIPE-funded projects have assisted various groups—businesses, including women-operated businesses; and business associations—to formulate policy positions, represent a unified voice before the government, and educate their members on policies that affect them by helping them develop a national business agenda. The key to any national business agenda is participation. For example, the Federation of Egyptian Industries' national agenda included the following steps:

- Analyzing policies and forming recommendations;
- Meeting with members in open forums to discuss alternatives;
- Publishing in the media to gain input from concerned parties;
- Formulating policy reform programs;
- Publicizing the agenda; and
- Engaging in advocacy directed at the government, including the executive and the legislative branches.

These activities strengthen democracy by giving the private sector a greater role in shaping economic reform and commercial policies. The following are examples of how business associations in different countries contributed to reducing barriers to formality by advocating for market-oriented policy reform.

Nigeria

In 1998, the Nigerian Association of Chambers of Commerce, Industry, Mines and Agriculture (NACCIMA) outlined its positions on important business and economic issues in a booklet, National Business Agenda (NBA). This 33-page booklet discusses 30 major issues that are vital to the effective and efficient management of the Nigerian economy. They include tax reform, foreign exchange, privatization, external debt, non-oil exports, rural development, political stability, and reform of Nigeria's stock exchange.

The NBA was part of a strategy to influence public policy by actively engaging the government. According to NACCIMA's Executive Director, Lawrence Adekunle, NACCIMA's work, coupled with its National Business Agenda, has encouraged the government to remove a number of laws that inhibit competition. In particular, the telecommunications industry--previously a government-controlled industry--has opened to competition. The oil refining business is currently being opened up to allow private companies to import and sell oil. Moreover, the Nigerian government now seems more willing to listen to the views of the private sector.

(Continued on next page...)

Malawi

The National Association of Business Women (NABW) is a nonprofit organization in Malawi that supports small, women-operated businesses and promotes their interests within the government. In its "National Call to Action" the NABW identifies some barriers that women face in starting and developing businesses in four sectors: agribusiness, soft goods (textiles, garments, handicrafts), tourism, and professional services (legal, accounting, health, and consulting). The National Call to Action was launched at a national meeting in 1998, attended by high government officials. At the meeting, NABW members called on the government to reduce the barriers identified in the National Call to Action. They expressed particular interest in reforming Malawi's discriminatory land-titling system that prevents women from owning land and thus using land as loan collateral. NABW's work has begun to bear fruit. The NABW is providing input to government committees that are exploring ways to change the land-titling policy and improve government services to women-operated businesses. In addition, the government has agreed to adopt a preferential purchase plan whereby it will increase the amount of government supplies purchased from women-run businesses, and it will increase the number of women who can enter vocational training centers.

Paraguay

The Federation of Production, Industry and Commerce (FEPRINCO) represents approximately 70 Paraguayan business organizations from the industrial, manufacturing and commercial sectors and is the business community's principal voice vis à vis the government. In order to help unite the private sector in advocating for reform, FEPRINCO developed a National Business Agenda as a vehicle for launching a legislative advisory program. The agenda contains a general set of economic principles from which it will base specific policy positions on market reforms. The National Business Agenda reviewed the government's economic program and identified further reforms that would consolidate the country's transition to democracy and a market economy. The agenda also identified opportunities for reform in such areas as public administration, transparency in the policymaking process, electoral reform, investment in human capital, a new legal framework for informal economic activities, and poverty alleviation.

The agenda was beneficial because it presented a unified voice of the private sector to the government. It was also extremely instructive in informing both the business community and government policymakers about economic reform and thrusting them into the process of governance, thereby strengthening their commitment to democracy. The National Business Agenda has also helped to foster a closer relationship between FEPRINCO and the country's legislature, opening opportunities to work together to craft legislation. Members of congress now frequently request opinions and recommendations from FEPRINCO and its member associations. As a result, several new legislative initiatives have been approved in the following areas: copyrights and patents, leases, reactivation of the agricultural sector, construction of new roads and infrastructure, and modification of the use of social security funds.

Sources: Sullivan (1999) and CIPE (1998).

8.0. Workshop Initiatives

During the three-hour, CIPE workshop on the informal sector in São Paulo, participants suggested four particular initiatives designed to reduce barriers to economic and political participation (see Appendix B for a workshop agenda and participant list). Each initiative was supported by several, but not necessarily all, workshop participants. Together, the set of recommendations reflects the diverse proposals that participants put forth during the workshop.

Proposed initiatives:

- 1) The workshop participants urged that members of business associations and reform-oriented think tanks in each country collaborate to develop a national business agenda which uniformly articulates the concerns of entrepreneurs, and disseminate this agenda to the public, policy makers and legislators. This will contribute to laws and regulations for efficient, market-based activity and to informed, responsive policymaking thereby strengthening democracy.
- 2) CIPE is using this background paper as an advocacy tool to raise awareness about exorbitant costs of doing business that exacerbate informality and the pernicious impacts on political and economic reform of a large and growing informal sector, and to devise strategies to reduce barriers to political and economic participation. To this end, the revised version of this paper is available on the CIPE Web site in a section devoted to the informal sector and the cost of doing business (see www.cipe.org/events/conf/saopaulo/). This Web site section also contains useful examples of CIPE-sponsored projects that have been instrumental in lowering the costs of doing business in the formal sector, relevant articles and cases studies. Moreover, the site provides an opportunity for entrepreneurs to share information and best practices proven to reduce the cost of doing business and has links to Web sites of other associations, think tanks and concerned institutions involved in reducing barriers to formality. CIPE is having this revised paper translated into several languages. These versions will be available on the CIPE Web site and will be posted on the Web sites of CIPE's regional offices in Egypt, Montenegro and Russia.
- 3) Labor and other NGOs proposed working to increase the supply of micro-credit and business consulting services to the informal sector. CIPE concurs and will seek to cooperate in such initiatives. Examples of helpful services include:
 - micro-credit loan programs
 - courses on how democracy and market-based systems function
 - training programs on how to set up and run a business
 - courses on how to understand and comply with business-related laws and regulations, especially accounting and tax requirements
- 4) Many workshop participants supported the idea of developing a transaction costs index to measure the cost of doing business in different countries. CIPE commends

this suggestion and hopes that it will be acted upon by research centers worldwide.

9.0. CONCLUSION: BENEFITS OF REDUCING BARRIERS TO PARTICIPATION

The tables presented in section 3.0. indicate that the informal sector contributes significantly to production and employment. Yet these same entrepreneurs are politically and economically disenfranchised because of excessively high transaction costs. Consequently, members of the informal sector do not attain their true economic potential or contribute to a vibrant democracy. In many instances, the reform debate has been shaped by members of international or regional organizations or by national elites with little input from the public, particularly those in the informal sector. As a result, in many developing countries and nations in transition there is a growing sense of frustration and injustice especially among informal entrepreneurs who do not feel like they have benefited from political and economic reforms. Failure to respond to concerns from pro-reform formal entrepreneurs and members of the informal sector could have serious consequences for democracy and economic reform in these countries increasing the likelihood of a reverse wave of democratization (see Diamond 2000).

The key to facilitating the informal sector's participation in the formal economy and in the policymaking and lawmaking processes is to institute democratic governance in the public and private sectors. This entails establishing mechanisms, such as those proposed in the Sana'a Declaration by emerging democracy representatives, through which citizens can regularly voice their concerns and participate in policy and lawmaking, verify public and private sector activity and hold relevant public and private sector actors accountable. Using these means, private sector associations and citizens can advocate for reforms that reduce transaction costs, and encourage and facilitate formality. These measures will help make the public and private sectors more responsive to citizens' needs; they will also increase efficiency, transparency, accountability—in other words, corporate governance—and growth, and will reduce corruption. Moreover, if citizens are granted a greater voice in shaping the reform process, they will gain a sense of ownership over reform measures. This will strengthen democracy and help to build a broader pro-reform constituency essential in order for democratic and market-based reforms to be consolidated.

10.0. APPENDIX A: THE EMERGING DEMOCRACIES FORUM

With the rapid increase of globalization, the success or failure of a country's transition to a stable democracy and an open economic system takes on greater significance. Nevertheless, many countries have been struggling to make reforms with little or no support from the international community. What the leaders of these countries require is a chance to engage in an open dialogue with each other and with the international community about their countries' experiences, challenges and needs.

The National Democratic Institute and the government of Yemen created such a chance last June in Sana'a, Yemen, at a forum entitled "Managing the Twin Transitions: Political and Economic Reform in Emerging Democracies." The forum succeeded in bringing together political leaders-people like President Alpha Oumar Konare of Mali, Prime Minister Abdulkarin Al-Eryani of Yemen and speaker of Georgia's parliament Zurab Zhvania-as well as more than 160 other decision makers and key actors from the political, economic and society spheres. They were joined by over 50 donor representatives and experts.

Demonstrating remarkable unity, conference participants publicized their commitment to democratic principles through the Sana'a Declaration. The declaration serves not only as a pledge of these countries' commitment to democracy, but as a statement of why it is important that the international community support their efforts. The text of the declaration follows.

Sana'a Declaration

We who attended the Emerging Democracies Forum in Sana'a, Yemen, from June 27 to 30, 1999 from 16 countries, assembled to acknowledge our democratic achievements, to address common challenges we face in the transition to full democracy and to reaffirm our commitment to democratic rights and principles. The Forum was a unique gathering, bringing together a diverse group of participants from countries whose democratic advances are not well known.

We recognize that the transition process is not complete and that much needs to be done to consolidate our democratic systems and to implement further political and economic reforms. While we are proud to have joined the growing community of democracies, the international community has tended to focus on countries that are considered strategically more important or are in crisis. However, democratic progress in our states contributes to peace, stability and prosperity both within and beyond our borders.

Reflecting the importance of all sectors of society in this endeavour, the participants at the Forum included government officials, members of governing and opposition parties, and representatives of labor, business and civic groups from Benin, Bolivia, El Salvador, Georgia, Ghana, Guatemala, Guyana, Macedonia, Malawi, Mali, Mongolia,

Morocco, Mozambique, Namibia, Nepal, and Yemen. We represent a diversity of democratic experience, but our attendance at this Forum demonstrates the universality of the democratic idea. This group of nations with different traditions, cultures and historical experiences was brought together by a shared commitment to democracy and a belief that the promise of economic prosperity enjoyed by all citizens is more likely to be realized in a democratic environment based on respect for human rights, popular participation and the rule of law. We share a commitment to:

- pursue economic reforms and secure fundamental workers' rights, while making every effort to educate and build widespread consensus for these goals;
- improve protections for human rights for all our people;
- hold regular free and fair elections, with special attention to the need to build public confidence in the process;
- develop our legislatures as an essential instrument for broad public participation and representation, as well as for policy debate and oversight of government;
- empower democratic governance at local levels;
- deepen our commitment to, and implement measures to ensure, the full participation of women in political life;
- ensure that the rights of minorities are respected and that every effort is made to engage marginalized groups in the political process;
- broaden the democratic experience by adopting all reasonable means to encourage public access to, and participation in, the policymaking process;
- support the strengthening of civil society;
- uphold the freedom of the press;
- address the urgent challenge of corruption by instituting meaningful reforms, including those that increase governmental transparency; and
- foster judicial independence, enhance public access to legal redress and ensure that the laws are fairly applied to all.

Following are some examples of measures recommended by Forum participants that give concrete expression to our shared democratic principles.

The successful implementation of economic reforms is advanced by:

- transparent and inclusive decision making, the involvement of civil servants, the public, labor, business groups, and political parties in the design and implementation of reforms;
- a social safety net to meet basic human needs and/or a complementary poverty alleviation program; and
- a recognition of the role of the civic sector in the implementation of economic reforms, including the use of such groups to help deliver government-funded social services.

Public confidence in elections is enhanced by:

- working toward the establishment of independent election commissions that are nonpartisan or politically balanced;
- regulating, by legislation, government financing of elections to ensure that they are fair and equitable for all parties; and
- inviting election observers, whether domestic or international, to mount more comprehensive efforts, including the monitoring of registration and campaign periods.

The legitimacy of parties and legislatures is advanced by:

- the adoption by political parties of internal democratic procedures, ongoing training of political leaders and elected officials, and public accountability and transparency; and
- the implementation of legislative procedures that ensure public access to plenary and committee meetings, the holding of public hearings, and the provision of committee documents and bills to the public.

Public participation in democratic decision making is enhanced by:

- providing for private ownership of the media and ensuring the impartiality of state-owned media;
- ensuring that governments and political parties take measures to increase the number of women in parliament and appoint women to key government posts;
- conducting civic education in schools, non-governmental organizations, parties, and the media to address cultural, attitudinal and legal barriers to the political and economic participation of women; and
- encouraging governments and legislatures to enhance the viability of non-governmental organizations, including removing legal barriers and providing tax exempt status.

The achievement of good governance, the improvement of administration, controlling corruption and strengthening the rule of law can be advanced by:

- instituting public information mechanisms, such as freedom of information laws and the publication of regulations;
- depoliticizing and professionalizing the civil service; and
- implementing a comprehensive program to fight corruption, including institutions such as politically independent anti-corruption commissions, ombudsmen and auditors general, codes of conduct and financial disclosure rules, and open procurement processes.

As a result of this conference, we hope to establish mechanisms between our countries to continue the sharing of ideas and experiences through consultations,

exchange programs, an interactive Web site and other means. We also look forward to working together in a variety of international fora to promote democratic principles and practices.

The international community should renew its commitment to countries working to build democratic institutions and processes and dedicate the resources for this task. In particular, the donor community and the international financial institutions, in considering loans, aid and debt policy, should give priority to those countries implementing political as well as economic reforms. These political reforms include measures that advance popular participation, build public trust in elections and legislatures, and enhance government transparency and accountability.

Source: CIPE, *Economic Reform Today*, 1, 2000.

11.0. APPENDIX B: WORKSHOP AGENDA AND PARTICIPANT LIST

Time	Agenda/Participants	Organization/Country
09:30 –09:45	Welcome and Introductory Remarks: John D. Sullivan, Ph.D.	Center for International Private Enterprise, USA
09:45 –10:15	Speakers presented different theoretical, practical and regional perspectives:	
	Lee Benham, Ph.D.	Washington University, St. Louis, Missouri, USA
	Roberto Carvalho, Ph.D.	Atlantic Institute, Brazil
	Chris Darroll	Small Business Project, South Africa
	Petar Ivanovic, Ph.D.	Center for Entrepreneurship, Yugoslavia
	Ambassador Ozdem Sanberk, Ph.D.	Turkish Economic and Social Studies Foundation, Turkey
10:15 – 12:15	Round-table Discussion & Strategy Session <ul style="list-style-type: none"> • What are the barriers to participation in the formal sector? • What are examples of success stories or best practices in removing these obstacles? • What strategies and/or recommended actions need to be implemented to reduce barriers to participation in the formal economy in emerging democracies? 	
	Moderators:	
	Laszlo Kallay, Ph.D.	Institute for Small Business Development, Hungary
	John D. Sullivan, Ph.D.	Center for International Private Enterprise, USA
	Participants:	
	Maria del Carmen Acena	National Economic Research Center, Guatemala
	Ion Anton, Ph.D.	International Center for Entrepreneurial Studies, Romania
	Myriam Arabian	<i>Coordinadora Ciudadana</i> , Mexico
	Marc Bayard	Global Office AFL-CIO Solidarity Center, USA
	Alexandra Benham	Ronald Coase Institute, USA
	Lee Benham, Ph.D.	Washington University, St. Louis, Missouri, USA
	Roberto Carvalho, Ph.D.	Atlantic Institute, Brazil
	Aurelio Conchoso	Center for the Dissemination of Economic Info, Venezuela
	Viktor Chmyrov	Memorial Museum of Political Repression and Totalitarianism, Russia
	Chris Darroll	Small Business Project, South Africa
	Dragan Djuric	Confederation of Independent Trade Unions of Montenegro, Yugoslavia
	Camilo Ernesto Soares Mochado	<i>Casa de la Juventud</i> , Paraguay
	Emma Ezeazu	Community for Action for Popular Participation, Nigeria
	John Fernandes	International Confederation of Free Trade Unions, Belgium
	Hugo Fonseca, Ph.D.	Center for the Dissemination of Economic Information, Venezuela
	Somchai Homlaor	Forum –Asia Union for Civil Liberty, Thailand
	Mab Huang	Soochow University, Department of Political Science, Taiwan
	Petar Ivanovic, Ph.D.	Center for Entrepreneurship, Yugoslavia
	Davor Juric	Union of Autonomous Trade Unions of Croatia, Croatia
	Laszlo Kallay, Ph.D.	Institute for Small Business Development, Hungary
	Penn Kemble	U.S. State Department, USA
	Ana Knezevic	Union of Autonomous Trade Unions of Croatia, Croatia
	Catherine Kuchta-Helbling, Ph.D.	Center for International Private Enterprise, USA

	Lyudmyla Kudina	Youth Alternative, Ukraine
	Antony Lodwick	All Ceylon Federation of Free Trade Unions, Sri Lanka
	Abdel-Fatau Musah, Ph.D.	Centre for Democracy and Development, United Kingdom
	Andrij Nechyporuk	Lion Society, Ukraine
	Milena Milkova Nedeva	Oblik Association, Bulgaria
	Ayoola Modupe Ogunsola Obe	Civil Liberties Organization, Nigeria
	Benjamin O. Oloruntimehin, Ph.D.	Development Policy Centre, Nigeria
	Alberto Pfeifer	<i>Consejo Empresario de América Latina</i> , Brazil
	Cecilia Barbieri Quino	Office of the Public Defender in Callao and the Northern Cone, Peru
	O. Rudneva, Ph.D.	Kharkiv Centre for Women's Studies, Ukraine
	Ambassador Ozdem Sanberk, Ph.D.	Turkish Economic and Social Studies Foundation, Turkey
	David A. Smith	AFL-CIO, USA
	John D. Sullivan, Ph.D.	Center for International Private Enterprise, USA
	André Urani	Secretary of Labor, Brazil
	Ancuta Vamesu	Civil Society Development Foundation, Romania
	Raul Araoz Velasco	Chamber of Deputies, Bolivia
	Tim Wu	Asia-Pacific Public Affairs Forum, Taiwan
	John Zemko	Center for International Private Enterprise, USA
12:15 - 12:30	Summary of best practices, recommended actions, strategies and policy initiatives	
	Rapporteur: Catherine Kuchta-Helbling, Ph.D.	Center for International Private Enterprise, USA

12.0. APPENDIX C: THE GLOBAL SULLIVAN PRINCIPLES OF CORPORATE SOCIAL RESPONSIBILITY

The "Global Sullivan Principles," which have been endorsed by several multinational companies within the last year, were announced at the United Nations in November 1999 by Baptist Minister Leon H. Sullivan from the United States. In 1997, Rev. Sullivan drafted a similar corporate code of conduct for US companies operating in South Africa in an effort to abolish that country's apartheid policies. In his words, the overarching objective of these principles is "to support economic, social and political justice by companies where they do business," including respect for human rights and equal work opportunities for all peoples.

The Principles

As a company which endorses the Global Sullivan Principles we will respect the law, and as a responsible member of society we will apply these Principles with integrity consistent with the legitimate role of business. We will develop and implement company policies, procedures, training and internal reporting structures to ensure commitment to these principles throughout our organization. We believe the application of these principles will achieve greater tolerance and better understanding among peoples, and advance the culture of peace.

Accordingly, we will:

- Express our support for universal human rights and, particularly, those of our employees, the communities within which we operate, and parties with whom we do business.
- Promote equal opportunity for our employees at all levels of the company with respect to issues such as color, race, gender, age, ethnicity or religious beliefs, and operate without unacceptable worker treatment such as the exploitation of children, physical punishment, female abuse, involuntary servitude, or other forms of abuse.
- Respect our employees' voluntary freedom of association.
- Compensate our employees to enable them to meet at least their basic needs and provide opportunity to improve their skill and capability to raise their social and economic opportunities.
- Provide a safe and healthy workplace; protect human health and the environment; and promote sustainable development.
- Promote fair competition including respect for intellectual and other property rights, and not offer, pay or accept bribes.
- Work with governments and communities in which we do business to improve the quality of life in those communities-their educational, cultural, economic and social well-being-and seek to provide training and opportunities for workers from disadvantaged backgrounds.
- Promote the application of these principles by those with whom we do business.

We will be transparent in our implementation of these principles and provide information which demonstrates publicly our commitment to them.

Source: CIPE, *Economic Reform Today*, 1, 2000.

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