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**Informal Sector Enterprises in the Light
of New Institutional Economics**

edited by:
International Department
Institute of Small Business
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1. Introduction*

25 years ago the ILO introduced the term 'informal sector'. It was used to describe activities that account for a large part of developing countries' economies. They were characterized by: „(a) ease of entry; (b) reliance on indigenous resources; (c) family ownership of enterprises; (d) small scale operation; (e) labour-intensive and adapted technology; (f) skills acquired outside the formal school system; and (g) unregulated and competitive markets.”¹ Since 1972 the concept has become very popular and has been applied by different schools of thought for a wide range of purposes.² The ILO definition has often been challenged because of its multi-dimensional character or the validity of single dimensions was disputed. But its elements are still used to identify informal sector enterprises.

The main lines of debate on the informal sector in the seventies and early eighties were the definition of informality and the role of the sector in the development process. Two different schools shaped the discussion: the structuralist ILO approach and the Neo-Marxist Petty Commodity Production approach. The ILO economists argued that the existence of an informal sector is the result of a failed policy to promote industrial development. Informal activities were considered to be surplus labor that need to be absorbed by the formal sector. Neo-Marxist saw the informal sector as a consequence of capitalist development and the informal sector closely linked to the formal sector. Informal sector activities, they said, exist to undermine labor and social security standards. Nevertheless, both approaches advocated an active role for the state to help informal sector enterprises. The debate changed fundamentally, when the Peruvian Hernando de Soto presented a liberal approach to the informal sector in 1986.³ De Soto argues that the informal sector consists of potentially efficient and dynamic small entrepreneurs whose energy is suppressed by excessive public regulations. The state should restrain from intervening in the economy in order to unshackle this entrepreneurial energy. De Soto's *„El otro sendero“* became very successful and made a large impact on the practical and theoretical work on the informal sector. By now, the role of the state is disputed. The focus of research turned to the question how

* I wish to thank Thomas Ostendorf and Douglas Crompton for comments on this paper and for correcting grammatical mistakes. All remaining errors are my own responsibility.

1 International Labour Office (1972), p. 6.

2 See Moser (1994), Peattie (1987) and Rakowski (1994b) for details.

3 De Soto (1989).

public regulations and institutions influence the development of informal sector activities.

The analysis of institutions has gained importance in development economics as a whole during the last decade.⁴ The idea that a strong connection between the shape of institutions and development exists, has become prominent. The main institutionalist school of thought is the New Institutional Economics (NIE). It is disputed which areas of research belong to NIE. This paper refers mainly to transaction cost economics and the analysis of property rights. At the core of NIE lies transaction cost economics, which proposes that all transactions, i.e. „when a good or service is transferred across a technologically separable interface“⁵, cause costs. Individuals aim to minimize them. The choice of a specific institution or organizational structure influences transaction costs. So does the form of property rights and contractual relations.

It seems that NIE can render some new aspects to the debate of the informal sector. The purpose of this paper is to examine how the behavior of informal entrepreneurs and the growth constraints to informal enterprises can be explained with institutionalist arguments.

The next section reveals that, on the lines of NIE, informality means that economic activities by informal sector enterprises are not conducted using formal institutions, i.e. public laws and regulations, but other, informal arrangements. Section 3 takes a look at the reasons why informal entrepreneurs do not use formal institutions. The special characteristics of the informal institutions they use instead, are examined in section 4. Due to these special characteristics, the use of informal institutions puts informal enterprises at a disadvantage in many ways. The mechanisms which cause this are examined in section 5. As a consequence, informal enterprises in many developing countries neither have a chance to prosper while remaining informal nor a chance to become formal. If they want to optimize their activities, i.e. to minimize their transaction costs, they could only do so by relying on both formal and informal institutions. In section 6 this behavior, which is also supported by recent empirical research, is discussed.

4 An institution, as understood in this context, is a system of norms, including the instruments to guarantee them, which has specified objectives and aims to influence individual behavior (see Richter / Furubotn (1996), p. 43).

5 See Williamson (1985), p. 1.

2. Linking New Institutional Economics and the Informal Sector

The concept of the informal sector is not well defined. There are still disagreements on the definitions and the characteristics of informal activity. In the following section the perspectives of an analysis of informality by the NIE are examined.

NIE deals with the question of how individuals adapt their behavior to the constraints imposed by institutions, i.e. by specified systems of rules. It examines how the costs of economic transactions are influenced by the structure of property rights and contractual relations. Examining the prevailing schools that deal with informality, the legalist approach to informality, which is masterminded by the Peruvian Hernando de Soto, comes closest to NIE. De Soto considers all activities informal whose objectives are legal but are conducted illegally. With that he establishes a contrast of legality and illegality that is consequently identified with formality and informality. Defined this way, informal activities evade regulations that are imposed on legal activities by public authorities. In Peru, de Soto states, the official regulations are biased and serve only the interest of the local elite and the bureaucratic apparatus. Consequently, access to formality involves prohibitive costs. Outside official regulations separate regulations for informal activities evolve, but these do not provide sufficient protection for informal individuals' property rights and cause additional costs. With these arguments, de Soto conducts an institutional analysis in *„El otro sendero“* although not consciously by his own account.⁶ Deliberately, de Soto does not take up a theoretical stance and sees his position between the various approaches.⁷ Furthermore, the IID and de Soto restrict their work rigidly to practical matters in Peru. Therefore, they do not play any direct role in recent theoretical debates.

But if the direction of de Soto is followed and more closely applied to NIE, a distinction of formal and informal activity evolves as proposed by Feige:

„[F] economic agents are regarded as members of the ‚formal‘ sector of any economy when their actions adhere to, or are protected by, the established

6 *„It was only a month and a half ago (ca. September 1987, the author) when I visited Washington University in St. Louis that the Chairman of the Department of Economics informed me that we were really neoinstitutionalists. It's only now by reading Janet Landa's paper (Landa (1988), the author), that I understand we must, in effect, be somewhat close to being neoinstitutionalists.“* De Soto (1988b), p. 217.

7 See de Soto (1988a), pp. 31 - 40.

institutional rules of the game. Conversely, when their actions fail to adhere to the established rules, or are denied their protection, the agents are regarded as members of the 'informal' sector of the economy. [...] Members of the formal sector, constrained by a particular institutional set of rules, confront a different set of transformation and transaction costs than those faced by members of the informal sector."⁸

„[T]he informal economy comprises economic activities that circumvent the costs and are excluded from the benefits and rights incorporated in the laws and administrative rules covering property relationships, commercial licensing, labour contracts, torts, financial credit and social security systems."⁹

Basically, this definition will be used throughout this paper, but a few clarifications have to be added. Firstly, the 'established rules of the game', which the formal part of the economy adheres to, are understood as the official laws and regulations of the state and its subordinated regional administrative bodies. The use of the term 'established' may be misleading since even informal institutions can be quite stable. Secondly, tax legislation should be added to the list of laws and regulations.

In this paper an activity or an enterprise is termed informal if it does not comply with at least one of the official laws and regulations. Thus, the equation of illegality with informality is not adapted. Rather, informal enterprises may be partially legal. Furthermore, it seems advisable to restrict the term informality to microenterprises since empirical studies of the informal sector are normally limited to them.¹⁰

3. Barriers to the Use of Formal Institutions

Enterprises in the informal sector do not comply with certain official laws and regulations. This means they conduct their activity under a different set of institutions than formal enterprises. These 'informal' institutions have special characteristics that are discussed below. First, it has to be considered why economic activities are set up outside the formal institutional setting. Why do entrepreneurs

8 Feige (1990), p. 990.

9 Feige (1990), p. 992.

10 The maximum size of enterprises in informal sector studies differs between 5 and 20 employees. Self-employed workers are often included.

consider it more profitable to do their business illegally or why do they have no chance of legalizing it?

Three different factors can be identified that are responsible for the non-observance of public laws and regulations:

1. Regulations impose prohibitively high costs on formality.
2. Informal entrepreneurs lack the skills and the knowledge to comply even with simple regulations.
3. The state and its organs are too weak to protect private contracts and property rights efficiently.

The costs of legalization and of remaining legal may be divided into direct financial costs and opportunity costs.¹¹ The direct costs are taxes, fees, duties, social security contributions, and expenses to make the site of production and the produced goods and services comply with legal requirements. Additionally, opportunity costs emerge from the time it takes to carry out the different steps of legalization and to fulfil the requirements of legality.

The multitude of regulations an enterprise has to fulfil indicates that the costs to legalize an enterprise may be quite high.¹² An enterprise can incur legalization costs while fulfilling the following regulational requirements: The initial registration with different registers, the requirements concerning the enterprise's location,

11 See Lagos (1995), p. 120.

12 A handful of studies exists that try to quantify these costs for several countries. The most famous one was conducted by the IID for Lima in the mid-eighties: A simulation revealed that obtaining the 11 licenses needed to legalize a small garment factory would have taken 289 days. The expenses plus the loss of production during the ten month waiting time amounted to more than US\$ 1200, 32 times the monthly minimum wage at that time. To approve a small shop one had to go through three different institutions which took 43 working days and cost almost 600 US-\$ (See de Soto (1989), pp. 133 - 146).

The PREALC checked whether these results could be transferred to other countries. The legalization costs were examined for eight Central and Latin American countries by the end of the eighties (See Lagos (1995), pp. 114 - 120). It turned out that, in the countries examined, in general 20 to 30 steps were necessary to legalize an activity. One important result of PREALC's examination was that the number of steps did not necessarily correlate to the amount of time needed. This indicates that the speed and efficiency of the administration is an important factor influencing the size of legalization costs. Another factor is the organizational structure. The processes speed up the more they are decentralized. The financial costs of legalization also varied widely. They extend from about 13 US-\$ to legalize an industrial enterprise in Bolivia to almost 900 US-\$ for a similar enterprise in Guatemala. If these costs are related to the enterprises' revenue they amount from one to five percent of the annual revenue up to a quarter of revenue.

the various health and safety regulations, the registration with the revenue services, and the labor regulations.

In addition to the one-off formalization costs, there are ongoing costs incurred by formalized enterprises which were evaded during their informal existence. These are the costs in connection with payment of taxes and compliance with labor and social regulations.¹³ Such costs are considerable.¹⁴ Neither the usefulness of tax payments that enable the state and local authorities to provide public goods, nor the need for health and safety regulations, is generally disputed, yet the costs arising from these may be prohibitively high for micro and small enterprises wanting to operate legally.¹⁵ Many of these enterprises cannot afford formalization and formality and thus will have to rely on informal relations.

An important factor that limits the possibility to become formal is the lack of education of many entrepreneurs in the informal sector. For too many of them even simple regulations could be difficult to fulfil since their ability to read, write or calculate is restricted. This has the same effect as apparently excessive regulations. The costs to comply with laws and regulations become prohibitive. The affected people have, however, to conduct some economic activity in order to earn their living. They will do this in an informal institutional setting.

The inefficiency of public institutions is another factor that forces businesses into informality. In many developing countries the use of formal institutions incurs high transaction costs. When conducting their business, the entrepreneurs cannot rely on the judicial system to guarantee their property rights or contracts because it is slow, unreliable, costly to use, or corrupt. If the public laws and regulations cannot fulfil the tasks that are assigned to them it might bear lower costs to rely on informal institutions. The same holds if, as already mentioned, legalization costs are pushed up by an inefficient administration or non-enforcement makes the evasion of rules and regulations less dangerous.

13 See Lagos (1995), p. 125.

14 In the mid eighties the ILD examined 50 industrial small enterprises in Lima, each with one to five employees. On average the gross profit was reduced by more than 75 percent through legality costs. In a survey of 37 legal enterprises, the ILD further found that 40 percent of their administrative expenses were used to fulfil bureaucratic requirements (See de Soto (1989), pp. 146 - 151).

The PREALC also determined the costs of sustaining legality. The legality cost did at least double the legalization costs in the countries reviewed. Like in Peru, the payment of taxes was less important than the expenses to fulfil the labor laws (See Lagos (1995), pp. 124 - 126).

15 See Tokman (1992), pp. 18 - 19.

All these considerations give hints why it may not be desirable or possible for entrepreneurs to conduct their businesses under formal institutional settings. As an alternative they rely on informal institutions. The nature of these institutions is examined in the following chapter.

4. The Characteristics of Informal Institutions

If, for any reasons, an entrepreneur's activities are not subjected to formal institutions they will substitute them by informal ones. In this section it will first be shown that it is advantageous to create or use these informal institutions. This is done by a simple model. From this model emerge some propositions on the characteristics of informal institutions.

Creating a simple model about petty traders within the urban informal sector who try to protect their territory, Jagannathan describes how informal institutions emerge. His 'peanut seller model' elucidates the difficulties to protect informal property rights and identifies preconditions that are necessary to make informal institutions function.¹⁶ Jagannathan assumes that a trader is the sole supplier within a particular area. This trader is facing the problem of how to control his area, because he loses a portion of demand if a competitor appears in his territory. Since the trader has to stay personally at his location - to sell and to earn his income - he has to weigh the loss of income and the physical strain that arise from driving out the intruder, against the saved demand. As a consequence, the closer the intruder gets to the location of the established trader, the more likely it is that the trader tries to drive him out. One possibility to minimize the defense costs and therefore the transaction costs of his activity is to gather with other traders in informal groups. These groups share the common goal of keeping away competitors. Now an intruder does not face the resistance of only one trader but of a

16 See Jagannathan (1987), pp. 60 - 66. Jagannathan uses the following assumptions:

- 1) The model considers a simple activity like the street-trading of peanuts. The supply of peanuts faces a demand that is evenly spread across the area.
- 2) The demand curve for peanuts is kinked. A single trader has no advantage if he deviates from the market price.
- 3) Work is the sole factor of production.
- 4) The only significant costs are costs to acquire the peanuts and to keep away intruders from the market.
- 5) The trader is too poor to use means like advertising.
- 6) The trader has no formal right to carry out his activity at this particular place.

whole group. This lowers the cost of the 'attacked' and raises the costs of the intruder. Due to this effect, the area (and consequently the demand the peanut seller can control) is larger than if he was acting alone. The property rights to his area are guaranteed by the group he belongs to.¹⁷ They become more secure, and even valuable and tradable within a certain scale.

Which mechanisms make informal relations like the one described function? Between the members of the group of traders complex contractual relations exist since their cooperation lasts for a longer time. The arrangement in the example is only efficient if the threat to expel intruders is credible. Therefore, it is necessary that the members of the group mutually help each other in case of a conflict. There must not be an incentive for opportunistic behavior. Instead, implicit contractual relations must exist between the members of the group that influence their actions in favor of cooperative behavior.¹⁸ This is an important precondition for the stability of informal contractual relations and their ability to replace formal laws. In the case of the model „the participants are aware that a breach in contracts will lead not only to confusion - but of more importance - to a disappearance of the earning opportunity.“¹⁹

Other preconditions have to be fulfilled to guarantee the stability of cooperation within trader networks or other long-term informal relations: Individuals have to be sure that the behavior of the opposite party towards the contract, that is observed and anticipated while contracting, will be sustained in the future. If an informal contract has been stable over a longer period it can compensate for the lack of security by creating trust through fulfilled expectations.²⁰ This kind of trust can be obtained faster if the involved individuals are subject to stable behavioral norms. Norms are particularly stable and can facilitate informal contractual relations if they are internalized (i.e. they are part of the preferences of the individuals) and instrumentalized (i.e. their violation will be punished).²¹ This suggests that informal contracts between individuals with the same social and cultural background arise more easily and are more stable. Landa sees a proof of this

17 See Jagannathan (1987), p. 62. A group like this can consist of complementary traders at the same location or of similar traders at different locations.

18 Implicit contracts have the special characteristic that the advantages of a breach of contract are always exceeded by the advantages of serving the contract. See Richter / Furubotn (1996), p. 171.

19 Jagannathan (1987), p. 63.

20 See Jagannathan (1987), pp. 4 - 5.

21 See Jagannathan (1987), p. 26

proposition in the fact that the wholesale trade in many developing countries is dominated by 'foreign ethnically homogeneous middlemen groups'.²² The traders or middlemen belong to tight-knit groups. Their transactions are marked by personal interaction on family, religious or ethnic lines. Ethnic rules, mutual help, and reciprocity are imbedded into social networks. They serve as a kind of law that enforces contractual relations within the group. A breach of such contracts will lead to sanctions by the other group members.²³ This constrains opportunism within the group. Therefore, in multi-ethnic societies the boundaries of informal contracts will run on ethnic borders. Within these groups, similar internalized behavioral rules engender a mutual trust which does not exist between different groups.

The transaction costs within the homogeneous group are low if there is mutual trust. But at the same time this means that the costs of transactions between different groups are very high.²⁴ There is virtually no possibility for an outsider to penetrate homogeneous groups since he does not own the status of a group member. Social property rights emerge within the group that are not tradeable, or only so within a restricted range, and that are tied to the existence of the group.²⁵ An outsider first has to acquire reputation. But this is not costless. Consequently, a picture of highly segmented informal markets emerges. Economic transactions can only take place with low transaction costs within particular groups that are constituted through personal relations. The range of informal contracts however is limited because transactions across the borders of homogeneous groups impose high costs.

22 Examples are the Chinese traders in South East Asia, the Lebanese in West Africa or the Indians in East and Central Africa (See Landa (1988), pp. 76 - 77).

23 See Landa (1988), pp. 94 - 95.

24 See Jagannathan (1987), p. 35.

25 See Jagannathan (1987), pp. 31 - 32 and Landa (1988), pp. 100 - 101.

5. The Drawbacks and Costs of Being Informal

If informal sector enterprises cannot use formal institutions because of the factors discussed in section 3, then they have to rely on informal substitutes. The special characteristics and extra-legal nature of informal institutions confer costs and disadvantages upon informal enterprises attempting to concur with formal institutions. The following types of costs are examined in this section: First, the costs to sustain informality; second, the costs of lacking access to public law institutions; third, some constraints that arise from economic policy. Finally, the application of Williamson's concept of governance structures will show that the use of all types of contractual arrangements is in fact restricted for informal enterprises.

5.1. The Costs to Sustain Informality

An enterprise that is doing business illegally is always threatened to be 'discovered' by public authorities. The sanctions it faces in this instance depend on the laws and prevalent legal practices. Principally, sanctions can consist of

- the payment of fines,
- confiscation or destruction of goods and means of production, or
- expulsion from the present location.²⁶

Therefore, illegal enterprises' property rights to their means of production, to their stored goods and to their premises are limited. Informal entrepreneurs can avoid these restrictions by producing at such a small scale that they cannot be detected from the outside. They might even split up their production to different locations. In order to remain invisible they have to abstain from advertising and are excluded from particular markets, like trade fairs. Finally, they can avert an 'official' discovery by bribing controlling officers. This will guarantee an undisturbed work at least for some time.²⁷

26 See BMZ (1995), p. 29.

27 See Casanovas (1992), pp. 53 - 54 and de Soto (1989), pp. 153 - 155.

5.2. The Costs of Lack of Access to Public Law Institutions

Informal enterprises outside legality are excluded from using public law institutions. They cannot push through property rights to their means of production and to contracts with the help of courts or other organs of the public administration. Thus, they have to rely on themselves or on collective informal mechanisms for this purpose. This might even be sensible since the public law institutions in many developing countries are highly inefficient, slow and costly and therefore often cannot fulfil the task of guaranteeing property rights. The mechanisms by which legal uncertainty influences and restricts informal enterprises' structure of property rights will be shown in turn for the means of production land, labor and capital.

Enterprises that hold no formal titles to the land they work on face strong restrictions in the scope of their activities. A threat to be expelled from the land exists, but there are other constraints beside the direct withdrawal of the rights to use. The first of these deals with the possibilities to transfer property rights. The value of a plot of land is lower if the buyer cannot be certain about his permanent possession in the future. By a long-lasting possession the informal proprietor may signal the security of the property rights to the land. This will consequently raise its value, but it will also restrict the mobility of land since the informal proprietor can hope to increase the value simply by waiting.²⁸ Another problem is the transfer of ownership if there is no written title. If a contract is settled verbally or if a written agreement cannot be used as evidence in front of a formal court, there may be a chance for the former proprietor to break the agreement with impunity. Due to these risks of opportunistic behavior by contractual partners, the value of the acquired rights will decrease for the new proprietor. In addition, he cannot refer to customary rights and therefore faces a stronger threat to his property rights than his predecessor.

The use of the land by the actual proprietor will adjust to the prevailing uncertainty. If there is a danger of confiscation or expulsion it will be rational to invest in buildings only as much as necessary. The machinery will be small in order to be mobile and to limit the loss in case of confiscation.²⁹ Thus, due to these factors that restrict the property rights to land, the operations of illegal enterprises will

28 See de Soto (1989), p. 162.

29 See de Soto (1988a), p. 25.

not become very capital intensive. This tendency will be reinforced by difficulties to acquire outside capital.

Since it is impossible to use land without any legal title as collateral, the insecurity of property rights to land is the main constraint for informal enterprises to acquire capital. To allocate credit on the basis of land as collateral, formal banks need a certificate of ownership or the registration in the land register which normally does not exist. Another factor that limits the access to credit is the informal enterprises' lack of standardized accounting. For a potential creditor it is difficult to assess the creditworthiness of an enterprise that does not fulfil particular checkable criteria, like the existence of a balance sheet or the presentation of a credit record. Therefore, the risk to lend money to such an enterprise increases for the creditor.³⁰ Additionally, in many countries official interest rate ceilings exist that restrict the access to the formal credit markets further, since formal creditors are not allowed to compensate the increased risk through a surcharge on the interest rate. Due to this mechanism informal enterprises are crowded out of the formal credit markets and have to rely on informal sources.³¹

The same mechanism applies with respect to insuring the enterprise against risks, like fire, accidents, etc. Enterprises that operate illegally do not have the chance to cover these risks by formal insurance companies. Indeed, they have no interest in these enterprises since they cannot assess the risk they take. Therefore, the entrepreneur can only make provisions against existential risks by himself. Normally, this requires more resources than the balancing of risks that is inherent to an insurance.

Informal enterprises may also have difficulties in getting access to appropriate employees. Labor relations in the informal sector are denoted by a high fluctuation.³² If informal employers pay lower wages and cannot offer any formalized social security employees will seek to improve their working conditions by changing to the formal sector. Therefore, it is particularly difficult for informal entrepreneurs to keep qualified employees in the long term. Due to these problems, the productivity of labor of informal enterprises remains low.

The examination of the factor markets suggests that informal enterprises work in a less capital intensive way than comparable formal enterprises due to the lack of secure property rights. Their productivity of labor is low. Therefore, the prospects

30 See BMZ (1995), p. 32.

31 See Chickering - Saladine (1991), p. 192 and Liedholm (1994), pp. 81 - 82.

32 See Morrisson - Solignac Lecomte - Oudin (1994), p. 77.

for the entrepreneur and his employees to increase their income and the prospect for the enterprise to grow are restricted.

5.3. Discrimination Against Informal Enterprises Through Economic Policy

Informal enterprises are directly disadvantaged against formal competitors through features of the tax and tariff system. They face higher costs for means of production if they buy from formal enterprises since they cannot reclaim the indirect taxes that might be imposed on these goods. If informal enterprises use imported products they cannot profit from reduced tariffs. Also, informal enterprises are disadvantaged if they sell goods and services to formal enterprises since these cannot reclaim any pretax.

Furthermore, illegal operating enterprises do not have access to public promotion institutions and promotion programs. The possibilities to get advice and to profit from training schemes are restricted compared to formal enterprises.³³

Since illegally operating enterprises normally transact in cash and keep their assets in this form they are seriously affected by the 'inflation tax' in countries with a high inflation rate. Formal enterprises, however, can choose other methods of payment and investment. De Soto concludes that because of these disadvantages of informal enterprises, there is an one-sided transfer of resources from the informal to the private and to the public formal sector.³⁴

5.4. The Constraints of Institutional Arrangements Through Informality

The restricted range of informal relations, the costs to build up long-term contractual relations to suppliers, customers and creditors outside of existing informal ties, and the risk of opportunism in these relations constrain the entrepreneurial activity in the informal sector. If informal entrepreneurs aim to achieve a level of their activities that would minimize their transaction costs, they face various problems to create and to use institutional arrangements that enable them to carry out transactions. In the following section Williamson's concept of governance structures is used to clarify and to structure these constraints informal enterprises face.

33 See BMZ (1995), p. 31.

34 See de Soto (1989), pp. 155 - 157.

Transactions have three dimensions that influence the transaction costs of the various forms to organize activities. These dimensions are asset specificity, uncertainty, and frequency.³⁵ Depending on the frequency of a transaction, asset specificity and uncertainty are of varying importance. Because of this, different organizational arrangements - governance structures - minimize transaction costs.³⁶

A trilateral governance structure, i.e. the contracting parties rely on a referee to arbitrate disputes over the transaction, is supposed to be optimal for occasional transactions with highly specific factors. The use of such an organizational structure by informal entrepreneurs is restricted to a limited spatial, social or ethnic environment in which a third party is recognized by both informal transaction parties.

For frequent transactions with mixed-specific factors a bilateral governance structure is preferred. The contracting parties negotiate a contract that leaves its later adaptation and interpretation to the contracting parties themselves. Informal entrepreneurs are confronted with the same range of problems as with trilateral governance structures if they try to develop bilateral governance structures. Long-term contractual relations that adjust flexibly to changes of the contract's environment are, in case of an inefficient functioning of formal legal institutions, only possible within limited informal groups. Within these groups, behavioral norms that are necessary to build up long-term contractual relations have to be internalized and institutionalized in order to limit the probability of opportunism. If relations exist between such groups there is a risk that the contracting partner tries to be opportunistic and intends to appropriate the quasi rent, that occurred through specific investments into the transaction. Responding to this risk by creating specific safety mechanisms also requires resources that increase the costs of the intended transaction.

Avoiding these transaction costs by creating a unified governance structure, e.g. by integrating suppliers, leads to other problems. For frequent transactions that rely on highly specific investments a vertical integration would be the best option. But due to the particularities of informal labor markets, sustaining a high number of employees is difficult. Apart from this, the acquisition of other enterprises is constrained by difficulties dealing with the transfer of property rights in informal settings. If, nevertheless, an integration is successful and the informal enterprise

35 See Williamson (1985), pp. 52 - 61.

36 See Williamson (1985), pp. 72 - 79.

expands, the threat of being detected increases too. To ward off this threat is, once again, costly.

The market is the optimal institution to carry out transactions that do not need any specific investment. But if they use the market governance structure, informal enterprises are disadvantaged by the mechanisms that were described in the last section.

These considerations show that enterprises that operate illegally have limited prospects to lower their production and transaction costs by choosing suitable institutional arrangements. They rather have to use considerable resources to

- defend their status,
- protect property rights and enforce contracts while growing, and
- even out the disadvantages against formal enterprises on formal markets.

Due to these mechanisms, illegal enterprises are small, are not joint-stock companies, do not have many financial resources, and do not work with sophisticated technology. These constraints could be lessened though the transition to the formal sector, but neither the transition to legality nor remaining legal is without costs.

6. The Behavior of Informal Enterprises

In section 3 it was shown that formalizing an informal enterprise, i.e. making it work under formal institutions, might be impossible in many cases. Excessive regulations, poorly functioning public organizations, and the lack of ability amongst entrepreneurs raise the transaction costs of using formal institutions significantly. But relying on informal institutions instead, is no remedy to this problem. The last section showed that the possibilities of doing business relying on informal institutions are restricted in many ways. Consequently, if micro enterprises only had to choose between exclusively using formal institutions or exclusively using informal institutions their prospects would be bleak.

In developing countries formal institutions will exist side by side with informal ones because of the described weaknesses attributed to them. If one assumes that there is not only the possibility for individuals to choose between informal and formal sets of institutions, but also the possibility to choose some institutions from these different sets, an interesting possibility arises. For informal enterprises the simultaneous use of formal and informal institutions may be a way out of the

dilemma they face. They can seek to optimize their commercial activities using formal, i.e. public, institutions only as much as necessary to avoid the disadvantages of informality as well as to avoid the excessive costs of formality.

In detail, this mechanism will work on the following lines: The requirements of every single law or regulation create a particular profile of advantages and disadvantages to an informal entrepreneur. This profile is shaped through the institutional environment and internal characteristics of the enterprise. The entrepreneur will, as far as possible for him, weigh up the advantages and disadvantages and will, with regard to this, choose an appropriate behavior. This means he will follow particular laws and regulations that have a net advantage for him, and he will evade the ones with a net disadvantage. Due to this behavior, the contrast of illegality and legality that is often assumed when informal sector enterprises are examined, blurs. A variety of intermediate states between the two extremes appear that is used by a multitude of informal entrepreneurs. To them, partial legalization and legality is the optimal strategy to lower the transaction costs of their activities.

The factors that determine whether an enterprise will fulfil a law or regulation, i.e. will use a formal institution, can be divided into external and internal factors. The external factors comprise of the structure of institutions which surround the enterprise. The internal factors are the characteristics of the enterprise itself.³⁷

The following external factors determine whether an enterprise complies to a law or regulation:

- The privileges an enterprise may obtain by complying.
- The complexity of the procedures, the amount of time and the costs that are associated with the fulfilment.
- The importance that is attached to the particular law or regulation by the public authorities and the severity of its enforcement.

The specific internal characteristics of an enterprise that could influence the decision to comply to a law or regulation are factors like the size, the type of activity, the location, the age of the enterprise, and the personal preferences of the entrepreneur himself.

Due to differing external and internal factors, the structure of costs and benefits that evolves from various regulations, is not the same for all enterprises. There-

³⁷ This division seems to be somewhat artificial if one keeps in mind that the structure of an enterprise is strongly influenced by the institutional setting in which it works. Nevertheless, this division is useful when considering data from different countries.

fore different decisions to comply with laws and regulations are taken. Informality is settled on a continuum between total legality and total illegality. On this continuum every microenterprise tries to find an institutional environment that lowers the transaction costs of its activities.

Recent empirical research on the behavior of microenterprises by the OECD and the ILO supports this finding.³⁸ Although the examined microenterprises are thought to be informal, many of them are registered, pay some taxes, or comply to certain other regulations. While some fulfil all their obligations and some none, a large portion of enterprises remains somehow semi-legal, fulfilling only selected obligations.

Nevertheless, it is difficult to forecast which enterprise will comply with which regulation. Determining the factors that lead to differences in the overall registration rates of microenterprises in different countries seems to be possible. They follow the lines of the external factors mentioned above.³⁹ But when examining the internal factors that make enterprises in the same institutional environments differ, not all prove to have a statistically significant influence. Examining data from Niger and Swaziland, McPherson and Liedholm found a correlation between registration and the type of activity of an enterprise, its location (capital of provincial town), its size and the gender of the entrepreneur.⁴⁰ For data from Ecuador, Chile and Jamaica, Klein and Tokman found a correlation between registration and the enterprise's size and partly between registration and its activity.⁴¹ Therefore, beside the findings that size and activity matter, it seems to be difficult to make any general statements on the internal factors that make entrepreneurs comply with a specific law or regulation.

38 The OECD examined more than 2200 microenterprises in seven developing countries. For detailed results see McPherson / Liedholm (1996); Mead / Morrisson (1996) and Morrisson / Solignac Lecomte / Oudin (1994). The PREALC carried out the country studies of the OECD survey in Ecuador and Jamaica. It published its results separately adding the results from a survey of more than 400 Chilean microenterprises. See Tokman / Klein (eds.) (1996).

39 See Klein / Tokman (1996), p. 37.

40 See McPherson / Liedholm (1996), pp. 484 - 486.

41 See Klein / Tokman (1996), pp. 49 - 51.

7. Conclusion

This paper aims to show the mechanisms that limit the development prospects of informal enterprises in developing countries. Using NIE for this purpose, the existence of different substitutable institutional environments - formal and informal ones - becomes central to the argument. While formal institutions comprise of the public laws and regulations that regulate business, informal institutions are relations that base on personal exchange, trust, and shared values. Due to this characteristic the range of informal institutions is restricted. Relations between different informal groupings are prone to high transactions costs.

In an environment where micro enterprises have to rely on informal institutions, because of high costs of formalizing their business, inadequate formal institutions and the lack of management skills, their prospects are bleak. All possibilities to organize activities through trilateral governance structures, bilateral governance structures, vertical integration or the use of markets are restricted due to the special characteristics of informal institutions. Consequently, it is not profitable for informal entrepreneurs to expand their activities or to use more sophisticated technologies.

For informal enterprises, one way out of this trap is partial formalization. Using selected public institutions (thus avoiding the disadvantages of informality as well as excessive costs of formality) they might find an optimal level of their activities. This thesis is supported by recent empirical research on the behavior of micro-enterprises that found that most enterprises that were considered informal are in fact doing business in semi-legality. If the institutional environments in different countries are examined, the factors that influence different behavior in different areas can even be identified. Nevertheless, in similar formal institutional environments it remains difficult to establish a correlation between the decision to comply to a formal law or regulation and the enterprises' characteristics.

These results highlight the usefulness and the limits of NIE's application to the informal sector. NIE gives valuable hints on the reasons for informal sector enterprises' structure. It therefore will help to identify policies that might improve the prospects of these small enterprises. But in explaining a single enterprise's choice of a special structure, NIE, and especially transaction costs economics, only capture a small part of the story.

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