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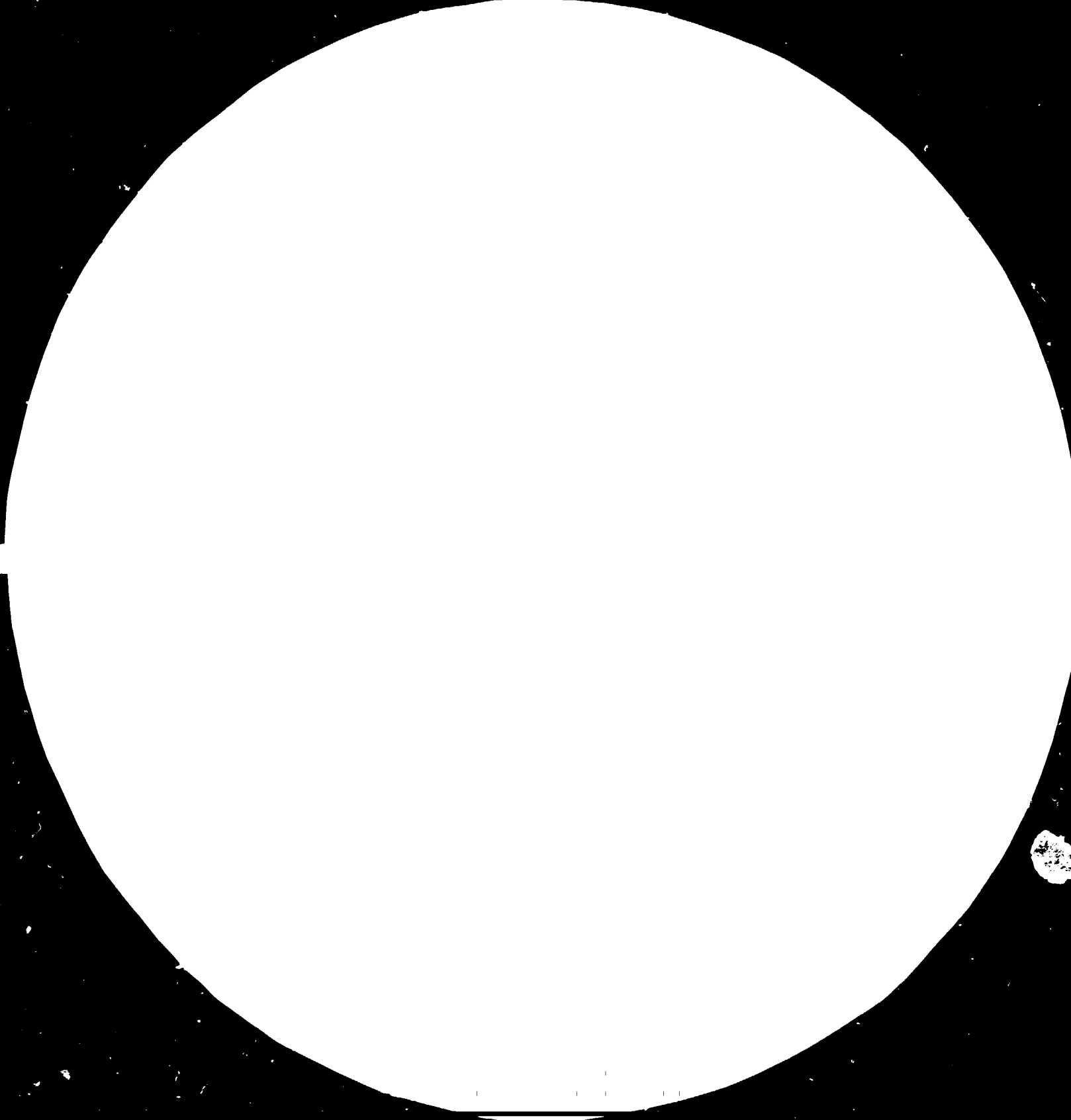
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THE INFORMAL SECTOR IN THE PERUVIAN INDUSTRY,

Consultant

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August, 1984.

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from: E. Kolm

CONTENTS

- I. DIMENSIONS AND CHARACTERISTICS OF THE PHENOMENON OF INFORMALITY IN PERU
 1. What is informality
 2. Magnitude of informality in Peru
 3. Principal characteristics of the informal sector

- II. THE INFORMAL INDUSTRY
 4. Dimensions and structure of the informal industry
 5. Factors of informality in the peruvian industry
 6. Case analysis: The textile and clothing industry, and the capital goods industry.

- III. POLICY RECOMMENDATIONS FOR REMEDYING THE INFORMALITY
 7. Fiscal policy
 8. Labor policy
 9. Other policies

I. DIMENSIONS AND CHARACTERISTICS OF THE PHENOMENON OF INFORMALITY IN PERU

1. What is Informality

It is not easy to give a distinct definition of what is understood by an informal economic activity, as it is subject to different concepts. This difficulty can be illustrated, for example, by merely observing the diverse terms applied to this sector: "parallel economy", "clandestine economy", "unofficial economy", "underground economy", "unregistered economy", "black economy", "shadowed economy", "illegal sector", "traditional sector", etc.

However, to attempt a good analysis and measurement of the informal sector, it is necessary to have a clear idea of what this sector signifies. According to F. Kafka ^{1/} the group of activities related to contraband and the drug traffic have "traditionally" been called informal sector. But the form how the term is used nowadays goes much farther. The informal sector may also involve activities undertaken by formal companies. It can be said that we are facing multiple facets and different degrees of formality. The hawker who has

^{1/} Kafka, F. (1984) "Sistema Informal". Instituto Peruano de Administración de Empresas.

no sales license, no private physical space for this purpose, nor pays a sales tax, is informal. The firm which, being constituted and registered declares only part of its production or sales, is informal in part. An independent worker engaged in business activities in his/her own domicile, etc., would also be informal.

Perhaps the best manner of defining the informal sector is by identifying the diverse activities it covers. Without intending to provide a complete classification, we can consider that the following would be informal activities: ^{1/}

- a. Trade activities: include ambulant sales of all types, whether seasonal or permanent, with partial or total dedication, established (with a fixed site in the street) or strictly ambulant.
- b. Productive activities: include unipersonal productive activities as well as those performed by a group or association of individuals, which can in turn be or not be relatives. For instance, this category would include small unregistered clothing workshops, unlicensed mechanical workshops, small factories which may be registered but evade labour provisions, those self-employed, etc.

1/Based on the classification submitted by F.Kafka (1984), op.cit.

- c. Tax evasion activities: here are included entities which are duly registered and recognized, but which declare or invoice only part of their activities, the remaining activities thus being informal. Although tax evasion exists here, it also exists in the other cases, and thus it is necessary to distinguish between diverse degrees of informality.
- d. Criminal activities: include drug traffic, theft, prostitution, contraband, etc.
- e. Other activities: include family and domestic employees, mendicancy and others which reflect disguised unemployment, such as automobile caretakers, practitioners, apprentices, etc.

2. Magnitude of the Informal Sector in Perú

No complete study exists at present to permit precise knowledge of the volume of the informal sector in Peruvian economy. However, some partial studies undertaken in the country allow us to estimate the magnitude of the informal economy, although only in urban zones, and with usually aggregate indicators.

Already in the past decade, attempts were begun to measure the informal urban sector. In 1975 it was estimated that in the urban areas, 53% of employment was generated by the informal sector.^{1/} In a recent

^{1/}Webb, R. (1975) "The Urban Traditional Sector in Peru". World Bank (mimeo). Cited by F. Kafka.

study^{1/} it has been estimated that in 1981 the number of persons occupied in the informal urban sector in Peru amounted to 1'370,000 (42.6% of urban employment) while in 1983 this figure reaches 1'723,000 persons, (51.3% of urban employment). Both studies identify informality with unemployment. Another study^{2/} points out that the informal economy may signify over 60% of the Lima-Callao gross production and 70% of the urban labour force, that is, over 2.2 million people.

If we observe that the total occupied population in Peru exceeds 5.5 million persons, it is evident that the informality is a phenomenon of great social and economic importance in the country.

Complete information is also lacking with respect to the sectorial composition of the informal economy. The most important study is the one made by the Ministry of Labour through a poll of 720 establishments or informal productive units, carried out in

1/ F. Kafka (1983). op.cit.

2/ Cited in "Caretas" (Oct. 1983). This publication presents advances of an unpublished study undertaken by the "Instituto Libertad y Democracia", but fails to explain the methodology of the estimate.

1982 in Lima-Callao.^{1/}

Table N° 1 shows the structure of the productive units of the informal sector per branches of activity. It is seen that trade (basically hawkers) is the most important informal activity (52%), followed in order of importance by industry (19%), with textiles, leather and footwear predominating with 8%, and then transport (12%), services (11%), and construction (6%).

As to employment, from Table N° 2 we can see that the Commercial Sector absorbs 47% of informal sector workers, while industry employs 27%.

3. Principal Characteristics of the Informal Sector

The same poll allows us to meet important aspects of the informal economy in Metropolitan Lima, such as size of the informal firms, sources of financing, cost of credit, intensity of use of capital, income, occupational category, place of work, type of purveyors, etc.

a. Size of informal productive units:

Informal firms are essentially small enterprises.

In Table N° 3 it can be seen that in the transport

^{1/} Chaves, E. and Bernedo J. (1982). "Los Rasgos Esenciales de la Problemática de los Estratos no organizados de la economía". Ministerio de Trabajo y Promoción Social.

TABLE N° 1

METROPOLITAN LIMA

THE STRUCTURE OF THE PRODUCTIVE UNITS IN THE
INFORMAL SECTOR ACCORDING TO TYPES OF ACTIVITIES

<u>TYPES OF ACTIVITIES</u>	<u>%</u>
Food and beverages	1.0
Textiles*, leather and Footwear	8.0
Furniture	4.0
Printing and publishing	1.0
Other manufactures	
<u>Total Manufacturing Industries</u>	<u>19.0</u>
<u>Construction</u>	<u>6.0</u>
<u>Trade</u>	<u>52.0</u>
<u>Transportation</u>	<u>12.0</u>
Repairing service (footwear, jewels, machinery)	7.0
Personal service	4.0
<u>Total Services</u>	<u>11.0</u>
TOTAL	100.0

SOURCE: Ministerio de Trabajo y Promoción Social. Encuesta a Estratos no organizados en Lima Metropolitana 1982.

* Includes wearing apparel.

TABLE N° 2

METROPOLITAN LIMA

LABOR FORCE IN INFORMAL PRODUCTIVE UNITS
OF DIFFERENT TYPES OF ACTIVITIES

<u>TYPES OF ACTIVITIES</u>	<u>%</u>
Trade	47.0
Industry	27.0*
Services	13.0
Construction	8.0
Transportation	<u>5.0</u>
	100.0

SOURCE: Ministerio de Trabajo y Promoción Social. Encuesta de Estratos no Organizados. 1982.

* This number corresponds to our own adjustment in order to separate the construction sector from the industrial one, keeping the same proportion of the productive units in Table N° 1.

sector (mainly taxis or minibuses), the greater volume concentrates in unipersonal enterprises (85% of the total). The commercial sector, basically composed of ambulant trade also incorporates a high percentage of unipersonal businesses (71%). The service and production sectors (which includes mainly industry) are those which comparatively show productive units of greater size.

b. Sources of Financing of the informal sector:

All informal activities are fundamentally financed with self-owned resources, and represent 80.5% of their financial sources (See Table N° 4). It is important to note that the credit derived from informal money lenders occupies a prominent place (16.4% of the total), while formal bank credit is almost nil (1.8%). Comparatively, industry uses more self-capital and less informal credit than the other sectors, while commerce is the sector which receives most informal credit.

c. Cost of Credit:

Credit is notoriously more expensive for informal enterprises than for the formal ones. In Table N° 5 it is seen that the annual nominal rate of interest can reach up to 500% for the enterprises, and in no event is it under 125%. At the same date

TABLE N° 3

METROPOLITAN LIMA

SIZE OF THE PRODUCTIVE UNITS IN THE
INFORMAL SECTOR BY TYPES OF ECONOMIC ACTIVITIES

Size	Total	Type of Activities			
		Production	Trade	Transportation	Services
1 Person	71.0	65.0	71.0	85.0	64.0
2 - 3 Persons	25.0	26.0	26.0	14.0	33.0
4 - 5 Persons	3.0	6.0	3.0	1.0	3.0
6 Persons or more	1.0	3.0			
TOTAL	100.0	100.0	100.0	100.0	100.0

SOURCE: Ministerio de Trabajo y Promoción Social

TABLE N° 4

METROPOLITAN LIMA

DISTRIBUTION OF THE PRODUCTIVE UNITS IN THE
INFORMAL SECTOR ACCORDING TO FINANCIAL SOURCES
AND ECONOMIC ACTIVITIES

FINANCIAL SOURCE	ECONOMIC ACTIVITY				
	Total	Industry	Trade	Transportation	Services
Own capital	80.5	86.6	79.0	78.2	79.4
Banks and Investment Firms	1.8	1.0	1.6	3.2	2.4
Informal credit	16.4	11.2	18.3	15.4	18.2
No capital was required	1.3	1.2	1.1	3.2	0
TOTAL	100.0	100.0	100.0	100.0	100.0

SOURCE: Ministerio de Trabajo y Promoción Social. Encuesta de Estratos no organizados. Mayo 1982.

TABLE N° 5

THE STRUCTURE OF INTEREST RATES IN THE
INFORMAL CAPITAL MARKET

(the rates are yearly and are valid for august 1982)

MARKET	LEVEL OF THE INTEREST RATES	
	Minimum	Maximum
<u>URBAN</u>		
Commercial credit	138 %	500 %
Suppliers credit	144 %	375%
Individual lenders	260 %	420 %
<u>RURAL</u>	125 %	230 %

Information of samples of the most representative money lenders in each market.

SOURCE: Susano, R., "Flujo de Fondos del Mercado Informal de Capitales", en Diagnóstico y Debate N° 2. Fundación Friedrich Ebert.

(August 1982) the rate of interest on the formal market was 80%, but diverse institutional and legal barriers exist which prevent informal enterprises from having access to these credits.

d. Intensity of the use of capital:

An important characteristic of informal enterprises is its low capital-labour ratio. The weighted average of capital per worker is 429 dollars, while in the formal sector it is 10,000 dollars approximately. The low intensity of use of capital can be explained as much by the high cost of credit which leads to the choice of more intensive labour processes, as by the features and needs inherent to informal activities (i.e., working in the street and not in an adequate site or building).

e. Work premises:

The use of homes as work premises is quite generalized among informal activities, especially in the production and services sectors (40.0% and 28% respectively, per Table No. 6. Scarcity of capital prevents the financing of suitable labour premises. Likewise, the use of productive processes using simple technologies and the employment of family workers, which cheapens the productive cost, lead to the use of the home as work premises. On the

TABLE N° 6

METROPOLITAN LIMA

DISTRIBUTION OF THE PRODUCTIVE UNITS IN THE INFORMAL
SECTOR ACCORDING TO TYPES OF ACTIVITIES AND LOCATION

TYPES OF ACTIVITIES	L O C A T I O N					
	Total	Factory	Home	Street		Door to Door Salesman
				Permanent Place	Movil Place	
Production	100.0	25.0	40.0	0.0	6.0	29.0
Trade	100.0	30.0	19.0	28.0	23.0	0.0
Transportation	100.0	0.0	0.0	10.0	90.0	0.0
Services	100.0	36.0	28.0	3.0	14.0	19.0
TOTAL:	100.0	26.0	22.0	17.0	25.0	10.0

SOURCE: Ministerio de Trabajo y Promoción Social. Encuesta de Estratos no organizados. Mayo 1982.

other hand, use of the street, whether in a fixed or movable site, is important in the commercial sector (51%).

f. Purveyors:

Another interesting indicator is the type of purveyors to informal enterprises. Here no differences are apparent between activities, which, by over 55% are supplied by the large enterprises (Table N° 7); this indicates a high degree of interrelationship between formal and informal enterprises, which in turn increases the magnitude of the informal economy, as presumably sales by the former to the latter are not registered and pay no taxes.

g. Occupational Category:

The presence of independent workers is quite significant in the informal sector, amounting to 57.9% of the total, the categories of laborers in the private sector (15.6%) and bosses (10.9%) being outstanding. According to these figures (see Table N° 8) no worker in the public sector would be informally employed.

h. Earnings:

Salaries and wages in the informal sector are as an average under those of the formal sector. In metropolitan Lima the average monthly earnings of

TABLE N° 7

METROPOLITAN LIMA

DISTRIBUTION OF THE PRODUCTIVE UNITS
IN THE INFORMAL SECTOR ACCORDING TO
ECONOMIC ACTIVITIES AND TYPE OF SUPPLIERS

SUPPLIERS	ECONOMIC ACTIVITY				
	Total	Production	Trade	Transportation	Services
Big enterprises	57.7	55.0	59.2	57.8	52.9
Stores and little enterprises	21.6	32.7	13.7	20.0	38.3
Several persons	17.2	10.7	21.3	13.3	4.4
One person	3.5	1.6	3.8	8.9	4.4
TOTAL:	100.0	100.0	100.0	100.0	100.0

SOURCE: Ministerio de Trabajo y Promoción Social. Encuesta de estratos no organizados, mayo 1982.

TABLE N° 8

METROPOLITAN LIMA

THE OCCUPATIONAL CATEGORIES IN THE INFORMAL SECTOR

(1981)

OCCUPATIONAL CATEGORY	%
Employer	10.9
Private employee (white collar)	7.9
Private laborer (blue collar)	15.6
Self employed	57.9
Non-payee family worker	7.0
Practitioner	0.7
TOTAL:	100.0

SOURCE: Ministerio de Trabajo y Promoción Social. Encuesta de Niveles de empleo en Lima Metropolitana. 1981.

the informal sector are equivalent to 55% of the formal sector (71 dollars, versus 127 dollars). Nevertheless, a 16.9% of informal workers perceives average earnings higher than those of the formal sector.^{1/}

^{1/} Carbonetto, D. (1984) "Condiciones de Trabajo y Calidad de Vida en el Sector Informal Urbano". Ministerio de Trabajo y Promoción Social.

II. THE INFORMAL INDUSTRY

4. Magnitude and structure

Based on the information hereto presented, we have been able to establish the global magnitude of the informal sector within Peruvian economy, as well as to show the relative importance of the informal industry, as opposed to other economic sectors of the country. In this section we will proceed to analyze the informal industry, establishing its magnitude as well as its structure. In the first place we will discuss the results of existing measurement studies, and subsequently we will present our own estimates in this respect.

In a study carried out by the World Bank and ONUDI^{1/} it appears that in 1978 the informal manufacturing sector represented 18.5% of the industrial value added of the country (see Table N° 9). For this calculation the artisans and industrial firms employing less than 5 workers were defined as belonging to the informal sector; while as formal were considered the enterprises registered in the Ministry of Industry, Tourism and Integration, that is, those employing

^{1/} Development and Policies of the Manufacturing Sector". June 1981. Program of Cooperation, World Bank/ONUFI.

TABLE N° 9

PERU: INFORMAL SECTOR MANUFACTURING

VALUE ADDED - S/. BILLION

	1971		1975		1978	
	<u>Value</u>	<u>Share (%)</u>	<u>Value</u>	<u>Share (%)</u>	<u>Value</u>	<u>Share (%)</u>
<u>Total Manufacturing</u>	73.7	100.0	156.5	100.0	504.7	100.0
Formal Sector ^{1/}	60.5	82.1	138.8	88.7	411.4	81.5
<u>Informal Sector</u>						
Small Industry ^{2/}	5.9	8.0	2.1	1.3	52.7	10.4
Artisans ^{3/}	7.3	9.9	15.6	10.0	40.6	8.1

^{1/} Includes registered establishments with 5 and more employees.

^{2/} Includes non-registered establishments with 1 to 4 employees.

^{3/} Includes non-registered establishments without employment, independent workers, home workers, and artisans not included in the Economic census or the Annual Statistical Survey.

Sources: Cuentas Nacionales, MICTI

5 or more workers.

We can obtain another estimate of the magnitude of the informal industry from the poll carried out by the Ministry of Labour, previously mentioned. On the basis of the enlarged figures of the sample chosen for said poll, it is estimated that the universe of persons employed in the informal sector in metropolitan Lima in 1982 amounted to 440,295 of which 27.0%, that is 118,880 persons worked in industrial activities. Comparing this last figure with the industrial employment registered by the statistics of the Ministry of Industry, Tourism and Integration (169,706 persons), it is concluded that in Lima and Callao, the informal industrial employment represents 70% of formal industrial employment.

For the purpose of counting with further information in order to compare the preceding estimates, and better precise the magnitude of the informal industry, we have undertaken to make our own estimates, which appear below.

The methodology for estimate consists of comparing the manufacturing employment figures registered by the National Population Census with those of industrial statistics. According to the 1981 National Census, there are in Peru 543,698 persons engaged in In-

dustry (see Table N° 10). Since the Census covers the whole number of homes in the country, we are allowed to learn of the economic activity of each individual, independently of if it is formal or informal. On the other hand, the industrial statistics of the Ministry of Industry, Tourism and Integration register for the same year only 234,015 individuals employed in the Sector. Defining this latter figure as the formal industrial employment, we can consider that the difference, that is to say, 309,683 individuals, constitutes the informal industrial employment. In relative terms, informal industrial employment in Peru represents 57% of total industrial employment.

The census information also allows us to make less aggregate estimates, classifying industrial activities by use or economic destination. Following the same methodology, that is, considering as informal the difference between the census figure and the industrial statistics, we can observe in Table N° 10 that informal employment exists principally in the consumer goods industry, while it is insignificant in those of intermediate goods. Participation of informal employment with respect to the total, in each activity, amounts to 72.8% in consumer goods, 21.5% in capital.

TABLE N° 10

INDUSTRIAL EMPLOYMENT BY ACTIVITY (CUODE)
(1981)

ACTIVITY	Total labor force in the Industry		Informal employment		Informal Employment Total Employment		
	Census (1)	% of Industry (2)	%	(3)=(1)-(2)	%	(4)=(3)+(1)	
Consumption goods	404,805	74.5	109,964	47.0	294,841	95.2	72.8
Intermedium goods	83,435	15.3	80,497	34.4	2,938	0.9	3.5
Capital goods	55,458	10.2	43,554	18.6	11,904	3.9	21.5
TOTAL:	543,698	100.0	234,015	100.0	309,683	100.0	57.0

goods and 3.5% in intermediate goods.^{1/}

Starting out from these figures, we can also estimate the informal industrial value added. If we presuppose that the value added per worker in the informal sector is similar to that of the small registered industries,^{2/} we can calculate the total value added of the informal activity, multiplying that figure by the number of workers employed in the informal sectors.

Data re: value added per worker in small industrial enterprises appear in Table N° 11, divided into consumer goods, intermediate and capital goods; while the results of our estimate are seen in Table N° 12. Here we can observe that in 1981 the indus-

1/An explanation of the reduced presence of the informal industry of intermediate goods is that it generally requires large investments and is easily detected by the registers, especially in the paper industry, oil refineries, steel, etc. Usually, they are also state-owned firms.

2/This supposition is valid in the sense that informal firms are generally small firms and therefore show the same features. However, there are also medium, and even large informal industrial firms whose production per worker is higher, which would elevate the value added per capita in the informal industries. This means that the results presented by ourselves here would be underestimated.

TABLE N° 11

VALUE ADDED BY EACH WORKER IN SMALL INDUSTRIAL ENTERPRISES

(1979)

ACTIVITY	Value Added by each worker (dollars)
Consumption goods	3,703
Intermedium good	3,895
Capital goods	4,378

SOURCE: Ministerio de Industria, Turismo e Integración

TABLE N° 12

FORMAL AND INFORMAL INDUSTRIAL VALUE ADDED BY ACTIVITIES

ACTIVITY	Formal Value Added ^{1/}	Informal Value Added ^{2/}	Total Value Added	Formal Value Added	Informal Value Added
	(Millions of dollars)	(Millions of dollars)	(Millions of dollars)	Total Value Added %	Total Value Added %
	(1)	(2)	(3)=(1)+(2)	(4)=(1)+(3)	(5)=(2)+(3)
Consumption goods	1,856	1,092	2,948	62.9	37.0
Intermedium goods	1,735	11	1,746	99.3	0.7
Capital goods	598	52	650	92.0	8.0
TOTAL	4,189	1,155	5,344	78.4	21.6

SOURCE: 1/ Ministerio de Industria, Turismo e Integración

2/ Own estimates, as a result of multiplying the numbers of the third column of Table N° 10 by the ones of Table N° 11.

trial value added of the informal sector is equivalent to 21.6% of the total industrial value added.

This figure is higher than the 18.7% estimated by the World Bank/ONUDI (see Table N° 9) and would indicate an increase of the informal activity. In more disaggregate terms, we can see that the highest degree of informality lies in the production of consumer goods (37%), followed to a much lesser degree by the industries of capital goods (8%) and intermediate goods (0.7%).

5. Factors of Informality in the Industry

Antecedents

Informality in Peru has very diverse and deep causes. Not only the economic factors can explain this phenomenon; one must also analyze the cultural, social, political, legal and historical aspects, which interwoven, have been molding Peruvian society along the centuries.

Fuenzalida^{1/} affirms that the history of Peru is marked by a continuous contrast, from its beginnings in the first times of the Colony, to contemporaneous Republican Peru.

"It is the contrast between a formal society constituted in terms of State institutions, Economy, Culture

^{1/}Fuenzalida, F.(1983). "Estudio del Sector Informal" (xerox).

and Religion framed within the distinct limits of legality; and an informal society which lives marginally or on the borderline of the codes and--although frequently keeping under its shadow--organizes itself in its structure and its dynamics, on the basis of common rules and survival strategies. For those who participate in this society, transgression of legal norms has never been a question of ethics but of opportunity.

From the times of the Conquest, the centers of formality have been the cities. These, with their society articulated from Spain, undertook to represent the Peruvian totality. With the rest of the country they maintained relations limited to exploitation and patrimonial dependence. They generated the illusion of being depositories of national identity.

The centralist tradition formed part of the republican heritage. The supposition of the definition of the identity of the Creole State as National State, was that the nation was the urban world and that the unit represented by the capital city was the unit itself of the country. The rest of the territory and its population turned out to be defined as an immense marginality to be civilized in the future. Thus was informality justified. The illusion of the Creole State

of being the National State, was maintained over a long period thanks to the concentration of the instruments of power and wealth in the hands of its representatives.

The capital and a few favoured cities could be, until well into the twentieth century, the privileged ghettos of the creole, who lived a culture of almost exclusively European roots and concentrated the instruments of power. The transformations undergone by Peru since the decade of 1950 had powerful repercussions, however, on the balance and equilibrium of relations between the worlds of formality and informality. The accelerated development of the structure of communications, changes in the economy, explosion of migrations to the cities, the Agrarian Reform, expansion of the domestic market, generated a new problem, provoking the eruption of the tensions and ambiguities accumulated during over four hundred years.

Contemporaneous Peru has ceased to appear as a territorial opposition between a certain number of urban enclaves of formality, more or less isolated in an immense hinterland of rural informality. The capital has become a microcosm of the national macrocosm. In a space dominated by the migratory presence of representations of Rural Peru, the last

ghettos of traditional creole domination retract, occupying a shrinking space. The new space is expressed by the invasion and overflowing of informal styles.

The incapacity of the State and Public Bodies to finance an expansion of services and a Program for Development to the extent and scale of the needs generated by population growth and social changes over the past decades, facilitates the multitudinous overflow of the masses, which exceeds all capacity of control on the part of the official mechanisms. The State response to the crisis of social control aggravates the situation even more; complication and delay in regulations and bureaucratic procedures; obsession with increasingly detailed legal and processal norms; wild proliferation of labyrinthic situations in the administrative system suffocate and strangle national life, generating bottlenecks which reduce even more the real efficiency of government apparatus. The economic and social costs of formality and legality become so high that, for a multitude of producers, businessmen and workers informality appears as the only alternative for survival. Competition arising from the world of informality against those who prefer to keep within the framework of the law, also

forces the latter to resort to informality with increasing frequency, as the only resource in order not to be displaced from the market".

Economic Factors

Concentrating our attention on the economic aspects of the causes of informality, the problem can be set out in terms of the costs and benefits of formality or legality as opposed to informality or illegality.

Such costs and benefits are of two types^{1/}. In the first place there is the cost of the legality arising from the entry into the market or activity. This is the cost of registering and fulfilling pertinent requisites. The other type of cost is that of operating formally that is, a cost derived from the operation or function of the enterprise, more than its entry into activity. Both types of costs need not be the same. The cost of registering does not depend on the cost of operating.

A formal enterprise can face a strong registry cost, but a low operating cost. For instance, it can resort to promotional lines of credit granted by the government. But at the same time, it has to comply with labour regulations, social security charges, and the industrial community, which mean higher operative costs and less

^{1/} Kafka, F. op.cit.

profits. On the other hand, the informal enterprise does not pay the cost of registering, but is obliged to pay high rates of interest for informal credit, although this could be compensated by a lower cost of labour, or by unpaid income and sales taxes.

Precisely, the aforementioned types of economic factors explain strongly the causes for informality in Peru. Per studies carried out and according to statements by the actual informal businessmen interviewed, the determining structural elements of informality are basically three: proceedings for constituting a formal business; the tax system, and labour legislation. In addition to these, there are allied factors derived from the economic crisis, which aggravate the phenomenon of informality in the country. We present below an analysis of these aspects.

a. Proceedings for constituting a formal industrial firm

The diversity of proceedings which exist for constituting and registering a formal enterprise in Peru are truly asphyxiating, and constitute an important cause of the existence of informal enterprises.

An industrialist who wishes to initiate an enterprise must engage in proceedings with six public entities: the Municipality, the Public Registers, the Ministry of Industry, the Ministry of Labour, the Ministry of

Economy and the Institute of Social Security. In each one of these institutions he is forced to make several types of registers, for which he must in turn fill diverse forms and present accrediting documents. In all, as shown in the next table, he must inscribe himself in 10 different registers and obtain 18 permits, documents, certifications and legalizations, for all of which he must fill 16 forms and applications and submit 37 documents.

Formally or legally, the proceedings in themselves are not costly, as public institutions charge very reduced tariffs or at times the service is free. However, in practice, there exist on the one part, a cash cost consisting of "bribes" which must be paid to officials to get the papers into circulation, and on the other part a real cost represented by the time which must be spent to complete these proceedings.

In an experiment simulating the constitution of a textile manufacturing company^{1/} it has been shown that even working for over six months, at the rate of eight hours a day, it is almost impossible to actually constitute a company, without paying bribes

1/ Experiment carried out by the Instituto Libertad y Democracia. "Caretas" magazine. October 1983.

PROCEDURES TO INITIATE AN INDUSTRIAL FIRM

MINISTERIO DE INDUSTRIA TURISMO E INTEGRACION

A) Registro Industrial

REQUISITOS

1. Persona Jurídica

- Certif. Zonificación
- L.E./Tributaria
- Solicitud
- Copia simple de la Escritura de Constitución de S.A.

2. Persona Natural

- Certif. Zonificación
- L.E. y L.T.
- Solicitud

B) Inscripción en el Registro de Productos Industriales Nacionales.

REQUISITOS

- Copia R.I.
- Copia norma técnica

3. Contrato legalizado que acredite el derecho a la planta (alquiler).

CONCEJOS MUNICIPALES.-

A) Autorización-Apertura Cert. Zonificación

REQUISITOS

- Solicitud
- Croquis de ubicación
- Pago variable

B) Autorización Municipal

REQUISITOS

- Solicitud
- Escritura Constitución
- Contrato de locación y/o documento que acredite la propiedad.
- Recibo de luz
- Registro Comercial
- Alumbrado y Limpieza Pública.
- Registro Nacional del Centro de Trabajo.
- Registro Industrial (MITI)
- Recibo de pago variable.

MINISTERIO DE TRABAJO Y PROMOCION SOCIAL

A) Inscripción

REQUISITOS

- Solicitud
- L.T.
- Escritura Constitución (P. Jurídica).

B) Autorización de funcionamiento del Centro de Trabajo.

REQUISITOS

- Solicitud

C) Registro Nacional de Centro de Trabajo.

REQUISITOS

- Solicitud

D) Registro de uso de Libros de Planillas.

REQUISITOS

- Solicitud
- Copia de Escritura de Constitución.

E) Libro de Pactos y Contratos.

REQUISITOS

- Solicitud

F) Solicitud de Inspección

I.P.S.S.

A) Inscripción

REQUISITOS

- Libro de Planillas, Sueldos y Salarios, autorizado por el Minist. de Trabajo y Promoción Social.
- L.T. del empleador (original y copia)
- Certif. domiciliario
- Licencia Municipal
- R.I. (original y copia)
- Escritura Constitución
- Formulario D.J.
- L.E. & Carnet

B) Chequera de Bonos

- Fonavi
- Imp. General Ventas
- Imp. Remuneraciones
- Imp. a la Renta

DIRECCION GENERAL DE CONTRIBUCIONES-MEFC

A) Inscripción

REQUISITOS

- Solicitud
- Copia L.T. (entidad)
- Copia Escritura y Estatutos

B) Libreta Tributaria

REQUISITOS

- Llenar formulario (pers. jurídica o pers. natural)

C) Constancia Tributaria

REQUISITOS

- Llenar formulario

D) Registro Nacional

REQUISITOS

- Solicitud
- Formulario

E) Declaración Jurada de Asignaciones Cívicas & Donaciones.

F) Registro Comercial

REQUISITOS

- Formulario Banco de la Nación.

REGISTROS PUBLICOS

A) Minuta

Cuadernillos de papel sello 6° (Notario)

- Escritura Constitución de la empresa
- Pago de derechos notariales.

B) Legalización de Libros

- Libro Diario
- Libro Mayor
- Libro Inventario y Balances.
- Libro Caja
- Libro de Registro y Transferencia de Acciones.
- Libro Reg. Ventas
- Libro Reg. Compras
- Libro de Juntas Generales.
- Libro de Acta de Directorio.

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33
1

or resorting to powerful relationship and important lawyers.

Four months ago, the Ministry of Industry initiated experimentally, a new system of registry for small enterprises, which should contribute to reduce informality. Through this system, the businessman has to apply to only two public institutions; the Municipality and the Ministry of Industry and the officials of this latter institution undertake to carry out, free of charge, the proceedings with the other public institutions, in a term of 30 days. This can be considered as a "second best" type solution, since the number of proceedings is not really reduced, but carried out by the bureaucrats themselves instead of the businessmen.

b. The Tax System

The Peruvian Tax System is particularly complex, and the tax pressure which falls upon the enterprises which apply it strictly, is substantial. Thus the high profitability of tax evasion.

As shown in Table N° 13, with current taxes up to July 31, 1984, an undervaluation of sales of US\$1,000 generates a saving in taxes and other types of charges of US\$ 749. In other words, every US\$ 1,000 not declared as the firm's income, are equivalent to having

TABLE N° 13

MARGINAL INCOME OF THE TRIBUTARY EVASION
(Taxes valid up to July 31, 1984)

	<u>DOLLARS</u>
<u>Sales income</u>	<u>100,000</u>
- Value added 18%	-18,000
<u>Net Income</u>	<u>82,000</u>
-Industrial Community, Itintec, etc. 27%	-22,140
<u>Gross Profits</u>	<u>59,860</u>
- Profit Taxes 40%	-23,944
<u>Dividens</u>	<u>35,916</u>
- Dividend taxes 30%	-10,775
Net Profits	<u>25,141</u> =====

Subvaluate \$ 100,000 of sales income is equivalent to obtain profits before taxes of \$ 397,756

$$X = \frac{100}{1 - t}$$

$$X = \frac{100}{1 - 0.74859} = \frac{100}{0.25141}$$

$$X = 397.756$$

Where:

$$t = \frac{\text{Total payed taxes}}{\text{Sales income}}$$

$$t = \frac{18,000 + 22,140 + 23,944 + 10,775}{100,000}$$

$$t = 0.74859$$

obtained additional gross income or profits amounting to \$ 3,977.-

Recently, commencing on August 1, 1984, the government has reduced the value added tax to 8%, thus partly decreasing the profitability of evasion. Now, each dollar not declared as the firm's earnings, is equivalent to an additional gross profit of 3.55 dollars (see Table N° 14).

Elevated imposition rates on the value added, as on the benefits, together with the lack of an efficient tax control system, renders tax evasion, to a greater or lesser degree, a very much diffused practice.

This also explains why, the Value Added Tax being equivalent to 18% of the Value Added, its contribution is only of the order of 2% of the Gross Domestic Product (excluding that which falls on petroleum imports and by-products thereof).

One faces a vicious circle in which high tax rates make evasion attractive, and where high evasion makes taxes increase even more, one by one, and new ones are created. At present an industrial enterprise in Peru has to pay 25 different taxes.^{1/}

^{1/} A list of these taxes appears in Annexe I.

TABLE N° 14

MARGINAL INCOME OF THE TRIBUTARY EVASION
(Taxes valid since August 1, 1984)

	<u>DOLLARS</u>
<u>Sales Income</u>	<u>100,000</u>
- Value added tax 8%	- 8,000
<u>Net Income</u>	<u>92,000</u>
- Industrial community, Itintec, etc. 27%	-24,840
<u>Gross Profits</u>	<u>67,160</u>
- Profits taxes 40%	-26,864
<u>Dividens</u>	<u>40,296</u>
- Dividend taxes 30%	-12,089
<u>Net Profits</u>	US \$ <u>28,207</u> =====

$$X = \frac{1}{1 - t}$$

$$X = \frac{1}{0.28207}$$

$$X = 3.545$$

In reality the heart of the problem lies in the absence of effective control mechanisms. Not only is it very attractive to a firm to evade when taxes are high; this becomes a matter of survival among competitive markets in which other firms are also evading taxes.

To illustrate the point, Table N° 15 shows the comparison between a (real) clothing textile manufacturing firm located in the formal sector and another (supposed) one with identical characteristics, in the informal sector, and which therefore evades the bulk of the taxes.

The formal enterprise would bear costs 30% higher than the informal one. 20 points of the difference is explained by evasion of the sales tax, and the bulk of the remainder by non-payment of social charges (social security and related provisions such as the one for time of services). With the new Taxes on sales, the excess cost descends from 30% to 19%.

A similar situation exists in other industrial branches. Thus for instance, in the footwear industry the production costs of a formal enterprise are 35% higher than for the informal, while in capital goods the difference is 64% (see Annexes II and III). With the new taxes, these figures decrease to 31% and 49% respectively.

TABLE N° 15

THE COST OF BECOMING FORMAL IN THE
WEARING APPAREL INDUSTRY (1982)

(U.S. DOLLARS)

	Formal Enterprise	Informal Enterprise
<u>Operating expenses</u>	148,963	148,963
<u>Municipal Taxes</u>	220	173
<u>Internal Taxes</u>	31,658	
-Assets Revaluation tax	117	
-Income tax	1,444	
-Net worth tax	271	
-Value added tax	29,826	
<u>National Pensions System Tax</u>	6,940	
<u>Provision for retirement</u>	6,071	
Others	494	310
TOTAL	194,346	149,446

SOURCE: Own elaboration based on a non-published study of the Instituto de Estudios Económicos y Sociales.

c. Labour Aspects

One of the factors which mostly stimulates informality is related to the problems and legislation in labour matters.

In this area the rigidity of the labour relationship, the industrial community and social security are noteworthy.

i. According to current labour legislation for workers with over three years in the enterprise, the termination of the labour relationship is extremely difficult, even in situations of indiscipline, excess personnel or even, the firm's difficult economic situation. This rigidity has fostered low productivity, excessive bargaining power by unions in wage discussions, lack of discipline and in many cases the bankruptcy of firms.

Labour costs have become a fixed cost, which has deprived firms of the capacity to adapt to changing market conditions, particularly in a period of strong recession and rapid technological changes. This is a decisive stimulus to informality in its different forms. In view of these norms, businessmen have adopted several outlets:

- Purchase of the worker's resignation.
- Rapid personnel rotation (the worker is dis-

missed before three years have elapsed).

- Sub-contracting workers from other firms.
- Not placing workers on the firm's payrolls, thus also avoiding Social Security payments, and therefore entering the area of informality.

ii. The industrial community was created in 1971 by the Military Government for the declared purpose of fostering harmony between workers and employers within a system of business co-management. Besides establishing the distribution of 10% of profits amongst the workers, an entity denominated Industrial Community was created in each industrial enterprise, with over five employees. This entity would receive, in company shares, 15% of the years' profits until it held 50% of its social capital. At the beginning the Industrial Community was seen as a mechanism to progressively transform private enterprise into worker enterprise. It was therefore a means to increase labour conflicts.

In many cases it became as a second union within the firm. On the other hand, the workers showed little interest in participating in the direction of the firms, barring those aspects which suited them directly.

During the second phase of the Military Government, the stock participation of the Industrial Community was limited to one third of the firm's social capital, the labour shares to be delivered directly to the workers to be sold freely thereby.

Moreover, recently, during the present Government, the Industrial Law provides an option for the workers to perceive 17% in cash as profit distribution, instead of receiving labour shares.

The Industrial Community and profit distribution by firms was in fact regressive, since the bulk of profits generated in industry arise from the larger firms counting with greater capital, and which pay the highest wages.

That is, they tend to increase differentials between earnings. On the other hand fiscal fraud has been stimulated and in fact, they are in the nature of a tax: by evading the industrial community, taxes on profits and dividends are also evaded.

iii. Social Security

Payments to the Peruvian Institute of Social Security (Social Security and Retirement Pensions), and to the National Housing Fund, to the National Service of Industrial Apprenticeship, etc., represent an increase of the payroll by somewhat more than a

fifth part. Its evasion is particularly attractive to firms with an intensive labour force, but in fact the greatest interest in avoiding these taxes derives from endeavouring to prevent the labour relationship from being officialized, thus avoiding the aforementioned rigidities in labour legislation. On the other hand, the poor operation of the Social Security in matters of health services, jointly with the superimposition of these to the services lent by the hospitals of the Ministry of Public Health, lead many of the workers, particularly the younger ones, to prefer an additional cash payment to being inscribed in the Peruvian Institute of Social Security.

- iv. In summary, the differentials in labour costs between formal and informal businesses are considerable. Thus in the case of the aforementioned textile manufacturing firm, average nominal wages of the formal firm were 92.4% higher with respect to the informal one (including charges for social security and social benefits). In terms of unit costs of production, this represents a higher cost of 13.8%.

In the case of a firm of metal-mechanics manufactures, even much more outstanding differentials

are encountered. Labour costs per head would be 118.1% higher in the formal firm, this higher cost inciding by 53.3% with regard to total manufacturing costs.

In practice much higher differentials can appear in labour costs per unit of product, due to variations in productivity. Informal firms frequently pay totally or partly for taskwork, in some cases achieving double the yield per worker.

6. Analysis of cases

From the estimates we have made it has been established that informal industry exists mainly in the area of the production of consumer goods, and to a lesser extent in that of capital goods. It is necessary therefore, to analyze these two sectors in depth.

As from the aforementioned poll by the Ministry of Labour, we can extract more precise conclusions concerning the structure of informal industry. Taking as a basis the information submitted in Table N° 1, we have again calculated the relative participation of informal industrial enterprises within the industrial sector, which appears in Table N° 16. There we can see that the most important informal branch is that of textiles, leather and footwear, representing 42% of informal industrial firms. There follow in

TABLE N° 16

STRUCTURE OF THE INDUSTRIAL INFORMAL
ENTERPRISES ACCORDING TO TYPE OF ACTIVITY

<u>TYPE OF ACTIVITY</u>	<u>%</u>
Textile*, leather and footwear	42.0
Furniture	21.0
Food and beverages	5.3
Printing and publishing	5.3
Other industries	26.4

* Includes textile wearing apparel

SOURCE: Own elaboration based on Table N° 1

order of importance the furniture industry (21%), food and beverages (5.3%), and printshops (5.3%), all of them producers of consumer goods.

Available information does not allow us to precise which branches pertain to the heading of "other industries", but eliminating the consumer goods area, which has already been taken into account, as well as intermediate goods, in which it was shown that informal activities barely exist, these must correspond to those of capital goods.

We now present a more detailed analysis of the magnitude and effects of informality in two of the industries operating with a greater degree of informality, that is, textiles and garment apparel, and capital goods.

a. Textile and Clothing Sector

The Textile and Clothing Sub-Sectors constitute an important sector of Peruvian industry. They represent 17.9% of industrial employment and 9.9% of industrial value added. They also constitute the principal heading of industrial exports, representing 43.5% of total non-traditional exports (yarns and fabrics, 32.1% and clothing 13.4%).

This sector comprises 10 groups of the International Standard Industrial Classification (ISIC),

whose relative importance can be seen in Table Nº 17. There it can be appreciated that the ISIC 3211, 3213 and 3220 are those with a higher relative incidence.

In view of the characteristics of clothing textiles activities, that is, low investment per worker, as also due to their easy commercialization, this activity shows a high and growing degree of informality. A study estimates that in Lima there would be 8,000 enterprises which manufacture clothing, 90% of which, that is, 7,200, are not registered.^{1/} Another study suggests that the personnel employed in unregistered clothing textile is easily as numerous as the registered.^{2/}

We have made an estimate which allows us to count with more exact figures, concerning informal employment in clothing industry. This method consists of multiplying the number of informal

1/ "Caretas", 1983. op.cit

2/ Cerritelli, L. (1984). "Estudio sobre competitividad de la industria textil y de las confecciones textiles". (xerox). The work does not explain the method of estimate and seems to basically reflect the intuition and experience of the author in the textile area.

TABLE N° 17

TEXTILE SECTOR: EMPLOYMENT AND PRODUCTION (1981)

ISIC		Employment %	Value Added (Millions of Dollars)	%
3211*	Cotton, woven and printed Fabrics	23,378 10.0	268.0	6.4
3212	Textiles except wearing apparel	1,452 0.6	12.5	0.3
3213	Knit wear	5,456 2.3	50.2	1.2
3214	Rugs and upholstery	315 0.1	4.1	0.1
3215	Ropes and cords	286 0.1	4.1	0.1
3219	Polyvinyl, artificial leather	237 0.1	4.1	0.1
3220	Wearing apparel	10,832 4.6	75.4	1.8
TOTAL TEXTILE		41,959 17.9	418.4	9.9
TOTAL INDUSTRY		234,015 100.0	4,189.0	100.0

* Includes ISIC 3216, 3217 and 3218

SOURCE: Ministerio de Industria, Turismo e Integración.

enterprises (7,200 per the previous estimate) by the average number of workers in each informal enterprise (1.75 per Table N° 3). This gives us a result of 12,600 workers in the informal industry of clothing textile, somewhat higher than the 10,832 registered workers, and which coincides to a great extent with the aforementioned estimate.

The existence of a wide informal sector in this activity is also evident, judging by other types of considerations, such as the structure and evolution of employment and production of formal activities. In effect, official figures (see Table N°17) show that in clothing textiles only a fourth of the total amount of individuals employed in the entire textile sector actually work, which is out of all proportion, since in the structure of the textile sector of other countries it can be seen that generally the clothing area absorbs double the employment of other industrial textile groups.

On the other hand, the economic crisis seems to be leading to a greater degree of informality in the sector, thus distorting production statistics. In the past two years, clothing textile manufacturing production and employment has been decreasing violently, reaching -28% in a single

year. Although it is true that the country is undergoing a severe industrial contraction, in this case the figures would have to be accepted with certain reserves, since, for example, regardless of such a reduction of employment and production, the importation of sewing machines has grown, from 4.7 million dollars in 1980, to 9.3 million in 1982.

What seems to be occurring is that the informal sector is an escape valve for many companies in view of the economic crisis. A formal enterprise has to compete in the country with two types of informal activities: clandestine enterprises which pay no taxes and therefore have the advantage of lower costs, which we have analyzed previously, and contraband. To remain on the market and face this competition, many formal enterprises are forced also to operate informally.

Contraband is an (informal) activity which notoriously affects the Peruvian textile industry, it having been estimated that the contraband of clothing textile manufactures amounts to 72 million dollars per year^{1/} (36% of local registered production).

1/ Ministry of Industry, Tourism and Integration (1983), "Política Industrial de Emergencia". (Xerox).

The Peruvian industrial textile's principal problem to overcome the competition of imported products, is the high internal cost of raw materials. Thus, for yarns and fabrics, raw material is the most important factor in the cost structure, representing 35% to 45% of the total, depending on the type of article.^{1/}

Generally, the internal price of the good quality cotton in Peru has been maintained at prices similar to those of the international market but in Peru, cottons of low quality and lower prices are not produced and their importation is forbidden. In the case of synthetic staples, they have an internal cost higher than international prices, as it is shown in Table N° 18. The high internal cost of polyester is due to the production scale at each of the plants existing in the country being reduced and inefficient. As to dralon, productivity exceeds the international one. All this explains the fact that textile imports mainly concentrate on

^{1/} The structure of average costs appears in Annexe IV.

TABLE N° 18

COST OF SINTETIC FIBERS

(U.S.Dollars)

	Peru	U.S.A.	DIFFERENCE (%)
Polyester-Filament yarn (150 denier)	4.67	2.05	128
Polyester-Fiber (1.5 inches)	2.29	1.67	37
Nylon-Filament (40 denier)	5.78	4.95	17
Acrylics-Fiber (20 inches)	2.54	2.20	16

SOURCE: Cerritelli, L. op. cit.

polyester, low quality cotton and nylon products, rather than dralon and similar products.^{1/}

b. The Capital Goods Industry

As a whole, the industries producing capital goods provide employment to 18.6% of industrial workers, and represent 13.0% of industrial value added, (see Table N° 19). Likewise they constitute an important export sector, with 15.5% of non-traditional exports.

In turn, the industries producing equipment for generation of electricity and for the mining industry, grouped basically under ISIC 3821, 3824, 3829, 3831 and 3839 represent 5.2% and 8.4% of employment and industrial value added, and 28.1% and 29.5% of employment and value added of capital goods.

This type of industries shows quite particular systems of informal operations, through the sub-contracting to third parties, or operating as enter-

^{1/} In a visit to the informal "Polvos Azules" market, main center for the sale of contraband products in Lima, it was verified that the principal competition from low-priced imported clothing comes from China or Korea, and these are 55% rayon or 65% polyester.

L. Cerritelli, op.cit.

TABLE N° 19

CAPITAL GOODS : PRODUCTION AND EMPLOYMENT (1981)

ISIC	Employment (people)	%	Value Added (millions of dollars)	%
381 Fabricated metal products	14,490	6.2	148.7	3.5
3821 Engines, fuel filters	249	0.1	2.6	0.06
3822 Agricultural and daily equipment	1,003	0.4	14.9	0.4
3823 Wood working machinery	383	0.2	3.9	0.09
3824 Equipment and machinery for the industry	1,760	0.8	17.1	0.4
3825 Data processing and recording equipment	174		1.3	
3829 Other electronic machinery	4,859	2.1	65.5	1.6
3831 Electric industrial machinery and equipment	2,183	0.9	27.3	0.7
3832 Radio, Television and Telephone equipment	3,011	1.3	62.4	1.5
3833 Domestic electric equipment	875	0.3	16.0	0.4
3839 Electric equipment and Fittings	3,177	1.4	63.6	1.5
384 Transport equipment	10,160	4.3	161.3	3.9
385 Controlling and optical equipment	<u>1,230</u>	<u>0.5</u>	<u>13.3</u>	<u>0.3</u>
TOTAL CAPITAL GOODS	<u>43,554</u>	<u>18.6</u>	<u>597.9</u>	<u>13.0</u>
TOTAL INDUSTRY	234,015	100.0	4,189.0	100.0

SOURCE: Ministerio de Industria, Turismo e Integración.

prises of the construction or the commercial sector, and therefore not fully registered in industrial statistics.

The industry which produces capital goods is completely vulnerable to the ups and downs of demand. Its sales depend on investment decisions which can easily be postponed. It is under such market conditions that norms such as those which regulate the cessation of the labour relationship, have decisively affected the situation of companies, and have frequently led to their bankruptcy.

In other cases they have led to the creation of more or less informal modes of operation. The mechanism mainly used is that of sub-contracting by some formal enterprise which takes over the final sale, and eventually some part of the productive process is undertaken by a series of workshops which operate more or less informally, and takes over the bulk of transformation processes.

Thus sales can be made abroad earning CERTEX, as well as to public or private entities or enterprises in the country, without major difficulties.

Finally, we must stress here the duality of situations which legally arise for a great part of the metallic manufactures associated with civil

works. If the responsible firm therefore is a civil construction firm its labour system is that specified for construction workers and, moreover, is not subject to the Value Added Tax.

This leads to such manufactures being undertaken directly by the construction firms, some of which possess great metal-mechanic workshops, or that only the services of enterprises registered as industrial firms are sub-contracted.

In a study it has been estimated that 85% of metal furniture proceeds from the informal industry and it sells to the public as well as clandestinely to recognized firms who stamp their brand on these products. It is also known that in the outskirts of Lima there is an assembly plant for engines and auto parts, which works with stolen materials. Surprisingly, a metal-mechanics workshop has also been found which manufactures parts for the armed forces.^{1/}

As to the informal production for mining equipment, we have detected that besides the six largest firms registered at the Ministry of Industry, there is another semi-informal industrial firm registered

^{1/} Caretas (1983). op.cit.

in part as a commercial enterprise, which even sells to the foreign market. This company exports for a value of 2 million dollars a year. If we presume, conservatively, that its sales on the local market are of an equal magnitude, and since the annual sales of the other six registered firms amount to 12 million dollars, we would have here that informal production of mining equipment is equivalent to 25% of formal production.

In the case of the industry for power generation, no significant informal production seems to exist, since almost the only purchaser is the Government, and firms must usually be fully registered, except for the possible existence of sub-contracting activities.

III. RECOMMENDATIONS AS TO POLICIES FOR REMEDYING INFORMALITY

7. Fiscal Policy

With regard to taxes, there are two ways to overcome the phenomenon of informality:

- a. Reduction of taxes hardest to supervise, simultaneously increasing those easily controlled.
- b. Radical improvement of fiscal control systems.

As it is improbable that the second way can be implemented on a short-term basis, the only way open is a change of the tax system, endeavouring to prevent evasion. In fact, both ways complement each other in the long run. No effective control system can be imposed without grave harm to the economy when the imposition rates are too high.

Although at short term it is very difficult to imagine that substantial changes can take place in the effectivity of the collection machinery, it can be completely transformed in a few years, and this has been fully demonstrated to be feasible in several Latin American countries where modern methods of control were implemented and the situation and discipline of tax administrators were improved.

As regards the first way, the following measures are suggested:

- a. Reduction of Value Added and Income Tax rates.

b. Increase of taxes on petroleum by-products to compensate the initial lower collection arising from the preceding measure.

If the prices of fuels were doubled, an additional collection could be obtained equivalent to all taxes paid on income by industrial enterprises, as well as all collected from the Value Added Tax. Even so, the price of petroleum by-products would remain within reasonable levels--approximately US\$0.50 per liter. The advantage of loading on the price of gasoline the reduction of the value added and income taxes is--in addition to the practical impossibility of evasion-- that petroleum by-products have a demand which grows much more than proportionately, than earnings as one climbs up the income pyramid. Direct or indirect consumption of power and particularly, of petroleum by-products is much lower in the lower than in the middle and high classes. It would be a form of truly progressive imposition. On the other hand, it is necessary to stimulate conservation of petroleum--in two more years Peru is likely to become an importer--, fostering the use of cheaper collective transport systems, reducing the strong environmental contamination in cities, as well as improving traffic flow and the condition of vehicles

to avoid unnecessary consumption of energy.

The incidence which doubling the price of fuels would have on costs of foodstuffs and public urban transport, would be very moderate. Thus for instance, within the price of potatoes the cost of transport does not exceed 30%, and within the cost of transport fuels participate by no more than 15%. Doubling their price would increase the price of potatoes by only less than 5%. It is important to note that this would be the most extreme example of the impact of the price of fuels on products, since the potato is the product which has less value per unit of weight. Also, as regards urban bus transport, fuel represents no more than a sixth part of its cost. Rather, if easier traffic flow is achieved by less use of private cars, the cost of collective transport could be reduced.

The fiscal revenues obtained from the earnings of industrial enterprises amount only to around \$100 to \$150 million, of which over two thirds proceed from merely 43 firms (some 11,000 industrial establishments with five or more workers are registered). Meanwhile, the collection from the Value Added Tax amounts to some \$300 million, excluding petroleum by-products and imports. Including these last two

sources, it would amount to some \$800 million.

Doubling the price of fuels, even assuming a decrease in consumption of 30% (estimated price elasticity is -0.3) would increase fiscal revenues by approximately \$1,000 million.

The elimination of the Value Added Tax and Income Tax has been suggested perhaps as an extreme option, in exchange for increasing taxes on fuels to moderate levels with moderate effects, with which it is shown how much easier intermediate situations would be, in which the option would be significant decreases in the rates of income and value added taxes, particularly if accompanied by decisive efforts to rationalize tax control systems.

Recently*, the Government has introduced modifications in this respect into the tax system, which constitute an advance as to the reduction of the profitability of evasion, and therefore, a curb on informality. Basically, the value added tax has been reduced from 18% to 8% and the tax on fuels has been increased from 60% to 123%.

However, as shown on Table N° 14, while present rates on profits and dividends, and the participation of the industrial community are maintained, pro-

*Commencing August 1, 1984.

profitability of evasion continues to be high. It is therefore suggested that the possibility of reducing such charges be given due thought.

To illustrate the importance of these taxes, we can point out that if the tax on profits and dividends, which presently is equivalent to 58% of the taxable income, is lowered to 25.55%, the profitability of evasion descends from 3.5/1 to 2/1. In other words, the additional gross profit for each undeclared dollar earned, falls from 3.5 dollars to 2 dollars.

B. Labour Policy

The extreme positions with respect to the length of the labour relation, is the reason that while a few --not even 5% of the Labour Force-- can remain in their work posts independently of their performance, dedication, capacity or even the situation of the firm, the great majority either has no access to a job, or holds it very precariously within informal enterprises.

In this area, two solutions are proposed:

- a. Application of the Agreement approved by the General Confederation of the ILO (International Labour Organization) concerning termination of the labour relationship, of 1982.

- b. Establishment of a substantial differential in the so-called indemnity for time of services (severance pay) between the event of voluntary withdrawal and the case of dismissal.

Article 4 of the ILO Agreement concerning termination of the work relationship establishes: "Article 4.- the work relationship of a worker shall not be terminated unless there exists therefor a justifiable cause related with his/her capacity or conduct, or based in the operational needs of the firm, establishment or service".

It should be pointed out that the above Agreement was approved by an ample majority by representatives of businessmen as well as workers and that it had the Favorable Vote of socialist countries.

For many years now there has existed in Peru the so-called indemnity for time of services, which the worker is entitled to collect at the termination of the labour relationship and the amount whereof is proportional to the number of years the individual has worked in the firm. For workers commencing after 1962 this amount is equal to one monthly wage multiplied by the number of years of work. Payment is made as a deferred wage. In other places, for instance in Argentina, this same type of payment exists

but only in the event of dismissal and as compensation thereof. In countries not in condition to implement a system of pensions for unemployment, this type of mechanism is the most practical way out to alleviate the worker's penuries arising from the loss of his work.

9. Other Policy measures

Treatment of the informal sector also requires another type of policies in diverse areas, such as the procedures for registry and proceedings, technical capacitation and assistance, commercialization and financing, efficiency and quality, etc.

Simplification of the proceedings for constituting an industrial enterprise should be stressed, seeking to unify existing proceedings. Also, the different Government agencies in charge of certain controls, such as sanitation and technical standards for instance, should coordinate their actions in order not to exaggerate the number of visits and inspections to plants, without ceasing to be firm in demanding fulfilment of the norms which society requires.

On the other hand, a permanent and intensive capacitation is required for small industrialists, to orient them as to their rights and obligations, and point out the advantages of being formal. In

this context, lines of promotional financing should be significantly expanded, to cover a greater number of informal enterprises which decide to become formal.

In the sphere of commercialization, a massive construction of markets and fair grounds is essential in the cities. The existence of a vast ambulant trade, which in Lima signifies close to 300,000 hawkers, is the best way to induce and facilitate the existence of informal industrial enterprises, which distribute their products through such sellers.

Finally, it is necessary to remedy the factors which lead to inefficiency and lack of quality in the industrial production, which often impels formal enterprises to operate as informal in order to compete, for instance, with imported products or with informal enterprises which purchase their inputs at lower-price contraband. At the same time that contraband is firmly opposed, rationalization is required of enterprises producing basic inputs such as synthetic textile staples, steel, cardboard, etc., and a reduction of the tariffs for the import of these products, thus reducing their cost and rendering the industrial enterprises who use such inputs more competitive:

ANNEXES

ANNEX I

TAXES APPLIED TO ENTERPRISES THAT ARE LEGALLY ESTABLISHED IN
LIMA AND CALLAO

TAX	RATE	PERIOD
1. Income tax	Until 150 U.I.T.* 32% From 151 to 1500 U.I.T. 42% From 1501 to 3000 U.I.T. 52% 3001 or more U.I.T. 57%	Yearly
2. Value added tax	8% since August 1st. 1984	monthly
3. Selective consumption tax	Up to 123% depending on type of products.	monthly
4. FONAVI Contribution	This contribution is used to finance a housing program. A corporation must pay 4% of its monthly remuneration The contribution applies to remuneration up to a maximum of five minimum salaries.	monthly
5. SENATI Contribution	For corporations with more than 15 workers 1.5%	monthly
6. ITINTEC	2% of the income before taxes	yearly
7. Nutritional Compensation Fond	For corporations with income over 60 U.I.T.	yearly
8. Remuneration Tax	2.5%	monthly
9. Fixed Assets Revaluation surplus tax	3% on the revaluation surplus	yearly
10. Capitalization of the Fixed Assets Revaluation Surplus Tax	5%	
11. Tax on corporation Stockholders' Equity	Until 9 U.I.T. 1.5% From 10 to 29 U.I.T. 1.8% 30 U.I.T. or more 2.5%	yearly

* U.I.T.: Tributary Impositive Unit. For 1983 1 U.I.T. = \$ 314.-

TAX	RATE	PERIOD
12. Tax on Non-Corporate Real Estate Property	The taxes applied on the total value of all real estate owned by a person within each province.	yearly
13. Municipal license for opening an enterprise	\$ 0.40 for each square meter in 1984	yearly
14. National Health Assistance System	5% up to \$ 155	monthly
15. National Pensions System	5% up to \$ 155	monthly
16. Labor accidents and occupational disease	Regulated in accordance with the nature and frequency of risks. Goes from 1% up to 12.2%	monthly
17. Special tax to beverages	1%	monthly
18. Special tax to International Fares	US \$ 1.00	
19. Special tax to money foreign exchange	1%	
20. Special tax to car owners	A ₁ A ₂ and A ₃ 1% C 2% A ₄ 3%	yearly
21. Municipal tax	Percentage of the electricity bills	monthly
22. Tax on vacant land	1 vacant urban land 0.5% 2 to 4 0.7% 5 or more 0.9%	yearly
23. Publication of balances	For the enterprises with income over 390 U.I.T.	yearly
24. Others	The enterprises with industrial community must separate 25% of their income before taxes, 10% to distribute between the workers, 13.5% to increase the labor patrimony and 1.5% for the patrimony of the industrial community.	

ANNEX II

THE COST OF BECOMING FORMAL IN THE FOOTWEAR INDUSTRY 1982

(U.S. Dollars)

	Formal Enterprise	Informal Enterprise
Operating expenses	11,150	11,150
Municipal Taxes	26	19
Internal Taxes	752	-
Assets Revaluation tax	18	
Income tax	24	
Net worth tax	85	
Value added tax	625	
Social Security, etc	247	-
Provision for retirement	2,861	
Others	43	34
TOTAL:	15,079	11,203

SOURCE: Own elaboration based on a non-published study of the Instituto de Estudios Económicos y Sociales.

ANNEX III

THE COST OF BECOMING FORMAL IN THE
CAPITAL GOODS INDUSTRY: 1982

(U.S. Dollars)

	Formal Enterprise	Informal Enterprise
Operating expenses	44,904	44,904
Municipal taxes	1,740	1,276
Internal revenue taxes	12,944	-
- Assets revaluation tax	443	
- Income tax	-	
- Net worth tax	477	
- Value added tax	12,024	
Social Security, etc.	5,601	-
Provision for retirement	4,886	-
Others	8,991	2,129
TOTAL :	79,066	48,309

SOURCE : Own elaboration based on a non-published study of the
Instituto de Estudios Económicos y Sociales.

ANNEX IV

STRUCTURE OF COST IN THE TEXTILE INDUSTRY (1979)

<u>COSTS</u>	<u>Clothing</u>	<u>Textile Fabrics</u>
Raw material	41.5	46.5
Labor	21.9	5.5
Other expenses	16.5	13.6
Amortization	2.0	9.1
Financial costs	6.9	17.1
Administrative costs	7.9	2.5
Sales costs	3.3	5.3
	100.0	100.0

SOURCE: Werner International Management Consultants. 1980

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