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"Working informally means that you don't have the help of a company behind you. I'd have liked a formal job, but this was the best I could do." These are the words 75-year-old Eva Hernandez said to BBC News in Bogotá, Colombia, during her daily work of selling newspapers that she is unable to read. While walking the streets of Bogotá, we could not go more than a few feet without being bombarded by street vendors, pitching everything from wooden maracas to hand-woven purses to fried empanadas, as they tried to make a coveted sale. These workers are a part of the majority of Colombian citizens who are members of the informal economy, an economy devoid of many of the social benefits and protections of the formal economy. While Colombia as a whole is seeing positive economic indicators in the form of healthy GDP growth and low inflation, workers in the informal sector must deal with the typically lower earnings and instability that accompany jobs outside the reach of the formal economy. With income inequality and poverty levels continuing to be major issues within Colombia, looking more deeply into the workings of the informal sector—how it emerged, why it persists, and what impact it has on the economy as a whole—will help Colombia solve some of the economic and social issues that have plagued it for decades.

Defining the Informal Economy

No study of the informal economy can begin without defining what constitutes the *informal economy*. For the sake of this article, the informal economy consists of economic activities that lie outside governmental regulations and, therefore, exclude workers from the protective benefits of formal employment. People working in the informal sector do not pay taxes, do not pay for or receive social security benefits, and do not have protections from unemployment or sickness. As of 2010, the informal economy houses 60 percent of the Colombian workforce (Mance), creating major problems in terms of the sustainability and effectiveness of many social programs that the government tries to implement: too few people pay into the systems to keep them afloat; the people in greatest need of the benefits often do not have access to them; and most people who work in the informal economy have difficulty escaping it. By exploring why the informal economy is harmful to Colombia, how it progressed to its present state, and what policies have been used in the past, this article addresses what policies might be most effective in helping Colombia combat the problems of its informal economy today.

Shortcomings of the Informal Economy

As a provider of work and income to people who need it the most, the informal economy does not, at first glance, seem like a problematic institution. However, a large informal economy can cripple an economy and stagnate social programs instituted by the government. An economy that lies beyond the control of a government or regulatory agency lacks vital protection for workers and provides a lower standard of living than formal employment. Informal workers must cope with irregular days of work, the lack of a minimum wage, an absence of health or safety standards, no contract enforcement, and exclusion from social security or pension plans. At the other end of the spectrum, a large informal economy seizes a portion of income that could be included in a country's GDP and allocated to social programs that are in great demand in developing countries like Colombia. Although an informal sector may be beneficial in the short run in providing immediate employment, it is not conducive to long-term growth. Moreover, it does not provide sustainable funding for social security or poverty reduction programs put in place by the government, often leading to decreased services and benefits of such programs. As citizens and businesses begin to lose confidence in the government's ability to provide economic and social stability, they see less of a need to pay taxes or support subpar social programs ("Removing Barriers . . . ," pp. 4–5). This vicious cycle limits the government's ability to enact the appropriate reforms or to act as a positive agent of change, one of its most important roles. For developing countries around the world hoping to alleviate poverty conditions and advance their economies, the informal sector has been a factor they have had to address for many years.

Modern Emergence of the Informal Sector

The informal sector is not new. It has existed around the world for centuries in rural areas as people often worked and lived their lives with little government interference in the form of taxes or social programs. The modern *urban* informal economy, which is the focus of this article, came about after World War II as many countries looked to modernize and enter the industrial age. Although many today do not see the informal sector as contemporary, the term, informal sector, and its study did not originate officially until 1972 when the International Labour Organization (ILO) began to study urban labor markets in Ghana (Losby et al., p. 2). Before this time, the informal sector or, more precisely, the economic activities it encompassed, was seen as a temporary phenomenon that would gradually disappear as a more formal economy took root. Experts hoped, and expected, to build up the economies of developing nations in the same way they rebuilt the economies of Europe and Japan after World War II. The ILO and other organizations believed that no matter what a country's political leaning (socialistic, democratic, etc.), with the right macroeconomic tools and funding, economic development could be achieved and informal jobs would be swallowed up by the formal economy. As is now evident, however, the informal sector was not a passing trend. Economies simply did not grow quickly enough to handle the increased demands of people who wanted modern, urban jobs. When workers had no formal job opportunities available to them, they turned to whatever form of work they could find (Bangasser, pp. 3–4). This was the beginning of the modern era of the urban informal sector.

Colombia followed a trend similar to that of the rest of the world. Like some other Latin American countries, the proportion of the population of Colombia that was urban grew rapidly, from 31 percent in 1951 to 52 percent in 1964 alone, as the country went through the process of modernization. In addition, the immense bloodshed of *La Violencia*[1] during the 1940s and 1950s forced approximately one million Colombians to move from violent rural areas into bigger cities (Flórez, 2003, p. 3). Although employment generation in cities should have been a main focus during this time, the thinking of the 1960s favored export promotion and capital formation instead, under the assumption that employment would grow as a result. It was not until the ILO conference in 1972 that the urban informal economy came onto center stage, gaining real prominence in the 1980s when it became one of the five "global themes" of the ILO's Medium Term Plan (Bangasser, pp. 5–13). The urban informal economy would remain an important issue in Colombia from the 1990s to the early 2000s, due to an escalation in violence that caused approximately two million people to be forcibly displaced from their homes in the countryside to urban areas. The number of workers in urban areas, along with the economic crises of the 1980s and 1990s, grew at such a rate that the economy could not respond rapidly enough. As a result, the supply of workers outpaced demand, and the informal economy grew to the level in evidence today.

Heterogeneity of the Informal Sector

While the informal economy encompasses a majority of the workforce in Colombia, not all of these workers are in the informal sector for the same reason. According to Guillermo Perry and William Maloney (p. 1), informal workers fall into two main groups: (1) workers who are excluded from the formal sector and (2) entrepreneurs who choose to exit the formal sector because it is of greater benefit to them. Each of these groups contains several different members who are in the informal sector for a host of different reasons. The excluded workers category—those who prefer to be formal employees but are hired as informal workers—includes anyone from employees of informal businesses to informal subcontractors within a formal sector firm. Those who choose to avoid the formal sector—to avoid paying taxes and the hassle of registering a formal business—range from small business owners to street vendors (Chen, pp. 2–3). The diversity of the informal economy and the variety of people it contains make it difficult for any government or organization to tackle the informal sector as a single entity.

Colombian Political Reform: 1990–2002

Prior to 1990, labor laws in Colombia were not conducive to growth in the formal sector. Although the laws were established with the good intentions of protecting workers and providing job stability, they caused many inefficiencies within the economy that hindered job creation. Hiring and firing regulations were among the most detrimental instruments put in place under these laws. In addition to establishing a strict "just cause" clause that made releasing workers difficult, the law raised severance payments to such a level that they became the highest nonwage labor costs of the period (Echeverry and Santa Maria, p. 5). Although current employees held on to their jobs, firms were hesitant to hire additional employees in economic upturns due to the added costs for each employee. Even if firms wanted to hire new employees, the minimum duration of a formal contract was one year. Without being able to legally hire temporary workers, firms turned to informal contracts or simply chose not to hire at all. A study sponsored by the Inter-American Development Bank estimated that the stringent hiring and firing laws before 1990 actually increased the unemployment rate by 10 percent and also increased the length of informal employment among low-skilled workers and the young (Kugler and Cardenas). Although the law was based on good intentions, it ultimately did not help those it most needed to reach: unemployed workers hoping to escape the informal economy. By helping those currently employed in the formal sector, the gap widened between the insiders—formal employees—and the informal employees kept on the outside.

Due to increased unemployment and informality, labor reform became a top priority in Colombia, as legislators introduced the Labor Reform Policy of 1990. The reform looked to increase flexibility and efficiency in the

[1]La Violencia was a decade-long civil war between the Colombian Conservative Party and the Colombian Liberal Party that cost the lives of more than 200,000 people.

Colombian labor market by reducing severance payments, expanding the definition of just causes for firing, and introducing temporary contracts (Flórez, 2002, p. 4). By allowing for more movement in the labor market and increased opportunities for entrance into the formal sector, it is clear this reform was geared toward helping informal workers at the expense of formal sector jobs. The reforms appear to have been successful, even at a limited level. Employment in the informal sector dropped by 2.5 percent from 1990 to 1994, and unemployment fell by a total of 4 percent, with labor reform directly contributing to a drop in unemployment of 0.4 percent (Echeverry and Santa Maria, p. 10). These numbers may seem insignificant, but, given the short period of time and the failure of the labor market in years past, they indicate the benefits of increased flexibility within the labor market for workers in the informal sector.

Although informal employment started to shrink at the beginning of the 1990s, a wave of social reforms swept through all of Latin America, including Colombia. In 1993, with the hopes of reducing inequality and improving health services, Colombia passed Law 100, a law that radically changed the public health and social security systems. In terms of healthcare, Law 100 increased contributions to the public healthcare system by formal employees from 6 percent (of their earnings) under the old system to 12 percent in the new system (8 percent paid by the employer and 4 percent from the employee). Poor individuals and the unemployed are enrolled in the welfare system but do not have to pay into it. In terms of pension reform, Law 100 more than doubled required contributions for salaried employees from 6.5 percent to 13.5 percent of their earnings. In total, the new law increased healthcare and social security contributions from 12.5 percent to 25.5 percent (12 percent for health contributions and 13.5 percent for pensions), making each worker significantly more expensive to hire (Flórez, 2002, pp. 5–6).

The impact of Law 100 was felt by firms in the formal sector, but entrepreneurs and the self-employed were hit even harder. Even though formal sector employees have to pay a greater percentage of their wages toward healthcare and pensions, a portion of their contribution is covered by employers. Entrepreneurs, on the other hand, must cover all of the costs on their own: an increase from 12.5 percent to 25.5 percent. These new changes make formal employment much less attractive to self-employed individuals in the informal sector who can obtain equal benefits in the informal sector—due to universal healthcare—without having to contribute a portion of their incomes to the systems. As such, the Colombian social protection system established under Law 100 actually promotes informal employment for several reasons: (1) a substantial percentage of the population would receive equal benefits whether in the contributing or subsidized group, so many opt for the free-of-charge subsidized group; (2) workers cannot easily transfer between groups, making them hesitant to accept a job offer that would put them in the contributing group; and (3) poor workers in the subsidized group are often eligible for more benefits and, therefore, do not want to lose any benefits by taking a job in the formal sector and joining the contributing group (Mondragón-Vélez et al., p. 11). When the Colombian government passed Law 100, it was hoping to improve the livelihood of its citizens and increase social welfare; unfortunately, this resulted in an increased incentive to join the informal economy.

With the effects of Law 100 lingering and the unemployment rate reaching historic highs of approximately 20 percent, the economic situation in Colombia at the end of the 1990s was anything but ideal. According to the Departamento Administrativo Nacional de Estadística (DANE) ("Measurement . . ."), Colombia's national statistics agency, Colombia's GDP shrunk by 4.3 percent in 1999 compared with a 0.18 percent annual growth in GDP for Latin America, while the urban unemployment rate reached 20.5 percent in September 2000 compared with a 10.7 percent average unemployment rate in Latin America as a whole. Policymakers recognized that lowering the level of unemployment was to be a top priority, but labor market rigidities and high nonwage costs prevented them from making the necessary changes. It was clear that another reform needed to take place. Under the leadership of newly elected president Juan Uribe, Colombia passed the Labor Reform Policy of 2002 that had the following provisions: (1) it reduced parafiscal[2] taxes from 8 percent to 5 percent of payroll, directly reducing nonwage costs; (2) it introduced an apprenticeship contract to allow for additional forms of hiring; (3) it introduced a regular working shift to eliminate extra payments for night shifts, Sunday work, and holiday work (as long as an alternate day of rest is provided); and (4) it established that work done outside of the regular working shift would be compensated with double wages or a compensating day of rest, unlike previous labor laws that had required both forms of compensation (Echeverry and Santa Maria, pp. 15–16). Thus, the 2002 reform increased labor flexibility and provided employers with more hiring options and incentives, all in the hope of decreasing unemployment and the number of informal workers.

The impact of the 2002 reform is difficult to measure and to disentangle from other macroeconomic policies; although unemployment clearly decreased after 2002 (a trend similar to that in other Latin American countries), GDP also rose over the same period and may have contributed to the positive results. However, most experts agree the reform had at least some positive impact. Alejandro Gaviria, a Colombian economist and development specialist, concluded the law had an especially beneficial impact on the hiring of apprentices—which grew 89 percent from 2002 to 2003 alone—and did indeed lower unemployment. However, growth in employment in the formal economy was less than expected, and some workers in the service sector saw a considerable reduction in income from the reform. Jairo Núñez, an economist involved in shaping the reform, found a more positive impact of the reform, noting that work in the formal sector increased 6 percent from 2002 to 2004 and that those in the greatest need—youth and the less educated—benefited the most from the reform ("Reforming Labor Law . . . ," p. 4).

From an examination of the last 25 years of labor and social reform in Colombia, it is clear that improving flexibility in the labor market and incentivizing firms in the formal sector to hire new workers has proved successful in increasing the number of formal sector jobs. What is also clear is the substantial positive impact that new policies can have on the scope and magnitude of the informal sector. To help craft productive reforms for the future, Colombians should look not only at what has worked for their country in the past but also at other initiatives used around the world that have produced positive results.

Learning from the Peruvian Experiment

One of the most attractive models for reducing the size of the informal sector hails from one of Colombia's Latin America neighbors, Peru. In the 1980s, Hernando de Soto headed the Institute for Liberty and Democracy (ILD) in the study of informal street vendors in Lima, Peru, in an attempt to solve the problem of informal employment among the many entrepreneurs around the city. By focusing on lowering the barriers to formalization, cutting the costs to businesses of regulation, and involving everyday citizens in the process, the ILD saw dramatic success in reducing the number of informal businesses. For example (Bettcher et al.),

- 382,100 Peruvian businesses were formalized in only three years.
- 200 informal market places in Lima were formalized by 2008.
- Businesses saved $692.5 million in red tape.
- 550,000 jobs within the formal sector were created.
- Land values doubled in the newly formalized markets.
- Major urban neighborhoods were revitalized.

De Soto and the ILD were able to turn the shacks and shanty shops that lined neighborhood streets around Lima into productive businesses in only a few short years by recognizing a key idea: instead of continually trying to combat the informal economy with more regulations and restrictions, the government should do all it can to make formalization easier. By simplifying the number of steps required to start a business, eliminating unnecessary red

[2]In Colombia, payroll taxes that help finance public social services—such as the Instituto Colombiano de Bienestar Familiar and the Servicio Nacional de Aprendizaje—are locally referred to as *parafiscales* or parafiscal taxes.

tape, and educating street vendors on effective managerial practices, the path to formalization became easier than ever before.

In order for the ILD to work effectively, the organization needed the support of a willing government. Congress passed an Administrative Simplification Law,[3] created a Unified Business Registry,[4] and established a Property Formalization Law,[5] all within only three years under the guidance of the ILD. The government also made sure to involve citizens in the reform process, asking them for their input and even hosting television sessions with the President of Peru. By involving citizens and playing an active role, the government succeeded in educating the people about the new changes as well as establishing credibility in its ability to run an effective economy. The move paid off not only for newly formalized businesses but also for the government, with tax revenues increasing by $1.2 billion from 1991 to 1994 (Bettcher et al.). All in all, the reforms generated remarkable job growth, increased entrepreneurship, built up entire neighborhoods, and boosted the morale and livelihood of the poor.

Peru's growth as a developing nation in Latin America is an encouraging sign that inroads can be made in reducing the informal sector in Colombia. De Soto and the ILD recognized that the informal economy is fueled by excessive regulations and bureaucratic complexities in starting or maintaining a business; when these obstacles were lessened, the switch from the informal to formal sector escalated. Colombia saw similar success when it reduced labor market rigidities in its own country, both with informal entrepreneurs and formal firms.

[3]Passed in 1989, the Administrative Simplification Law sought to simplify transactions between the government and businesses. It simplified over 400 administrative procedures, reducing costs in time and paperwork, and was primarily aimed at helping poor citizens in areas such as business, education, and housing.

[4]Created by the government in 1990, the Unified Business Registry consolidated procedures from many different agencies into one central location, greatly reducing the time and resources required to nationally register a business.

[5]Passed in 1988, the Property Formalization Law simplified the formalization process for extralegal real estate (properties not registered with the government), created a property registry, and created procedures for handling disputes.

Aiding Entrepreneurs: Reducing Barriers to Formalization

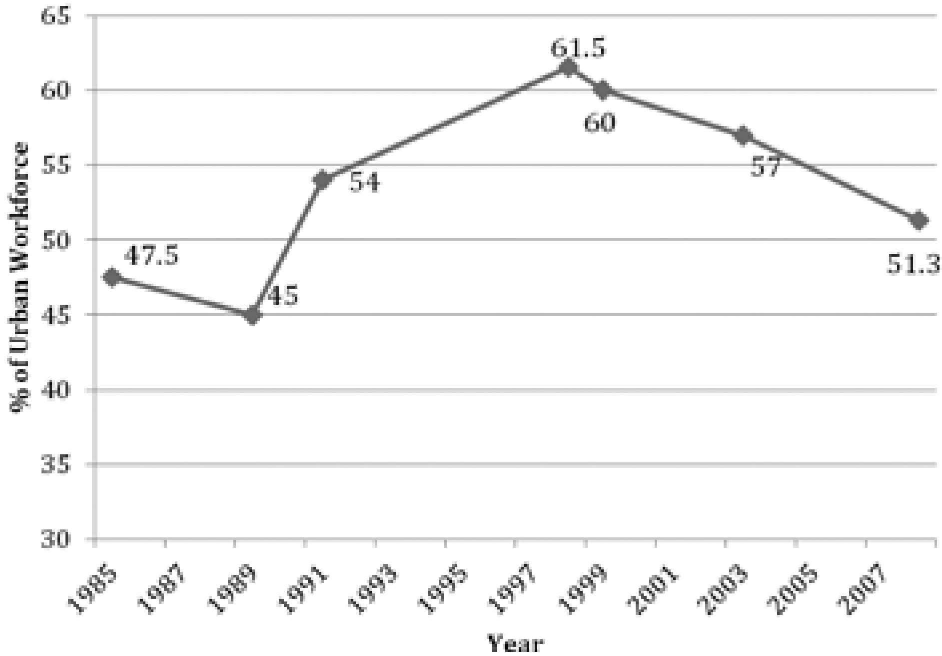
As the Peruvian experiment demonstrates, reducing barriers to formalization for informal entrepreneurs can have a substantial effect on decreasing the size of the informal sector. By simplifying bureaucratic procedures, Peruvian policymakers were able to help formalize thousands of businesses, create hundreds of thousands of formal jobs, and reduce business start-up costs by millions of dollars, all in a span of less than five years. Colombia would benefit from the same policies. According to the World Bank's "Doing Business 2013," Colombia is ranked 45th in the world with respect to its ease of starting a business; while it is fourth in Latin America, it still ranks far below the United States—which is ranked fourth in the world—and other developed countries.

As countries make the process of starting a business easier, they can directly increase the number of formal sector jobs by incentivizing informal firms to register their businesses. For example, Vietnam introduced its Enterprise Law in 2000 that streamlined the process of starting a business: it decreased the costs of starting a business. It reduced the number of required licenses and permits and cut the estimated time to start a business from 98 days to 7. According to estimates, 40 percent of newly registered firms after the implementation of the law had previously operated in the informal economy (Garcia-Bolivar). El Salvador followed suit in the early 2000s by creating "one-stop-shops" for formalization. These shops help businesses with the registration process, enter all their information—such as products offered, geographic location, production capacity, etc.—into a database, and then find procurement opportunities with other businesses within the system. This not only allows small businesses to establish themselves but also provides them additional help to stay competitive (Garcia-Bolivar).

Colombian policymakers have certainly made it easier to start a business in Colombia over the past decade by decreasing the number of bureaucratic procedures and days required to start a business. Businesses can now expect only 8 procedures taking 13 days to start a business, rather than the 19 procedures and

Figure 1

Size of the Colombian Urban Informal Sector



Sources: Echeverry and Santa Maria; Flórez, 2002; "Measurement of Informal Employment."

60 days that were required in 2004 ("Custom Query . . ."). However, one of the biggest remaining barriers to formalization is educating the public. No matter how easy or appealing the formalization process may be, if citizens do not understand the process they will not readily join the formal sector. By involving citizens in the process through a democratic discussion of the mechanisms and regulations involved with formalization, de Soto and his team were able to increase participation in the Peruvian formal economy simply by raising awareness. Colombia could benefit from a similar process in which government officials are open to ideas, criticisms, and discussions with citizens working within the informal economy. This would create feelings of trust in the government and its policies, feelings that are often lacking in citizens within the informal sector.

Formal Firms: Establish Flexible Labor Laws

In addition to decreasing barriers to formalization, policymakers must continue to promote flexible labor laws in order to encourage the hiring process within formal firms. Colombian history has shown that strict labor laws are not conducive to job growth in the formal sector. Figure 1 demonstrates the varying size of the Colombian urban informal sector from 1985 to 2007, a period when many reforms took place. As discussed previously, in 1990 Colombia implemented its first major reform of the labor market, making hiring and firing easier for firms and allowing for greater efficiency in the market. This reform caused the overall contribution of informal businesses to Colombia's GDP to drop 2.5 percent in only four years, going from 47.5 percent of Colombia's GDP in 1990 to 45 percent in 1994. However, in 1993 Colombia instituted social reforms with the passing of Law 100, the law that greatly increased contributions to social security and public healthcare from both the employer and employee. By the time the law was fully in place in 1996, the contribution of informal businesses to Colombia's GDP jumped from 45 percent in 1994 to 54 percent in 1996. The dramatic increase should not be entirely linked to Law

100, for Colombia was in the midst of an economic crisis at this time; but the burdensome policies put in place by the law caused firms to be even more reluctant to hire new workers.

With the economic crisis lingering, policymakers used a tool from the past and reformed the labor market once again with the Labor Reform Law of 2002. As described previously, the law increased labor flexibility and decreased nonwage costs. As a result, the contribution of informal businesses to Colombia's GDP dropped from 61.5 percent of the Colombian economy in 2002 to 60 percent in 2003. Although this is only a modest decrease, given the short time frame and the continued decline in the size of the informal sector in the years to follow, the numbers provide further evidence of the positive impact of the law on the informal sector. Altogether the results indicate that the informal sector is best reduced with flexible labor laws that allow formal firms to adapt to changing market conditions efficiently. Although social reforms seem like a great idea on the surface, they often hurt informal workers, the people they are trying to help most, more than any other group. Increases in parafiscal taxes and increased worker protection benefit workers who are already in the formal economy, but they also cause firms to be more hesitant to hire new employees. The result is usually an increase in unemployment and an increase in the size of the informal sector.

A Holistic Approach: Increase Incentives for Formalization

Any political or social approach aimed at decreasing the size of the informal sector ultimately needs to create more incentives for workers and businesses to be involved in the formal economy. Entrepreneurs, formal firms, and informal workers remain in the informal sector mostly because it is economically advantageous for them to do so. From a microeconomics standpoint, the benefits simply outweigh the costs. There are several ways that Colombian policymakers can increase incentives for formalization, each directed toward the major groups involved in the informal sector. For example, many entrepreneurs in small enterprises are hesitant to enter the formal sector because of tax reasons. To combat this problem, Brazil and other Latin American countries have created a single levied tax on revenues for small enterprises that replaced one or more of the following: the value-added tax, social security tax, and income tax. Brazil estimated that these enterprises enjoyed significant tax savings and created 500,000 new jobs in the formal sector as a result ("Removing Barriers . . . ," p. 31). By simply decreasing the costs of being in the formal sector, small firms were incentivized to formalize, and the economy benefited as a result.

Formal firms would respond in a similar fashion. As evidenced from the introduction of flexible labor laws, these firms are more willing to hire workers when the costs they would incur decrease. A firm has no incentive to formally hire workers when its financial liabilities increase substantially; it is more convenient and cheaper to simply hire them off the books. Policymakers need to take an active hand not only by establishing incentives for formalization—for example, by creating tax breaks for firms that add formal workers to the payroll—but also by educating firms about the benefits of full formalization. The U.S. Agency for International Development insists that more dialogue between government officials and the private sector is one of the best long-term initiatives for reducing the size of the informal sector. By showing firms the costs of the informal economy, what they can specifically do to help combat it, and how the long-term benefits of growing the tax base outweigh the short-term monetary gains from hiding informal activities, a government can actively pave the way toward greater formalization and a reduction in the informal economy ("Removing Barriers . . . ," pp. 36–39). Whether creating tax incentives for formalization, providing more health or pension benefits to formal employees, offering more business services to formalized firms, or offering several other initiatives, as the benefits of being in a formal economy start to outweigh the costs, people will begin the shift toward formalization. As this happens the informal economy will begin to shrink as well.

Conclusion

The intricacies and complexities of the urban informal economy have beleaguered Colombian policymakers and workers for decades as they strive to pull their country out of poverty and toward a brighter future. The informal economy in Colombia continues to promote income inequality, prevents the poorest groups from obtaining social services, and keeps the country from realizing its full economic potential. Although Colombia has experienced significant macroeconomic growth in the last decade, the majority of its workforce still remains in the informal economy. This means that the bulk of Colombia's economy is unaccounted for: it is not factored into the nation's GDP nor does it help support the government or its programs. By reducing barriers to formalization, establishing flexible labor laws, and increasing incentives within the formal economy, Colombia could begin the transition to an economy composed primarily of formal firms.

During the Martindale Center Student Associates' visit to Colombia in the spring of 2012, the streets of Cartagena and Bogotá were lined with these informal workers—sellers of produce, purses, necklaces, chotchkes, drinks, and paintings—all hoping to make a living for themselves in whatever way they can. What if these workers were incorporated into a viable, working economy? Such an economy would allow them to receive a pension, have greater access to credit to grow their business, and benefit from worker protection rights. Helping people obtain this status in the formal economy should be a top priority of Colombian policymakers; it is essential for reducing poverty and increasing economic development. The Santos administration has successfully worked at establishing a more peaceful, economically sound Colombia thus far, but the informal sector continues to be a concern. After we met with top Colombian officials and businessmen in Bogotá, it became clear that the country has the ability to reduce the informal sector. Growing the oil industry, attracting foreign investors, and favoring big business all appear to be lucrative options for the country. However, if Colombian policymakers choose to use the country's healthy GDP growth and favorable macroeconomic policies to instead change the makeup of their economy, Colombia could see a majority of its workforce within the formal sector and improve the livelihood of its citizens.

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