

Legal Empowerment and Informal Institutions
11-12 December 2006

The Commission on Legal Empowerment of the Poor is examining the relationship and relative functioning of informal and formal institutions in the following four areas, of with the objective of contributing to the legal empowerment of the poor:

- Access to justice and rule of law
- Property rights
- Labor rights
- Legal Mechanisms to empower informal businesses

By “legal empowerment”, we mean improving the capacity of the poor to have greater control over their own lives and livelihoods by means of the law.

Ideas for policy and program development in the above four thematic areas will be discussed in the context of development co-operation in an era of increasing aid. The presentation will begin with a brief general discussion of formality and informality, followed by the costs and benefits for development. This will then be related to development cooperation in general and in relation to increased aid.

In many developing countries, laws benefiting the poor exist on paper but not in practice unless the poor push for their enforcement. Modern economic theory stresses the importance of institutions for the performance of our economies. On the other hand, many are unaware of which came first. The key to creating wealth in the developed world is still the development of institutional structures that permit individuals to take actions involving complex relationships with other individuals far removed from any personal knowledge and extending over long periods of time. As Douglass North postulates, this is only possible with a third party of exchange: government, which specifies property rights and enforces contracts.

Companies around the world underreport employment, avoid certain taxes, ignore product quality and worker safety regulations, violate copyright and intellectual-property laws, or even fail to register as legal entities. The problem is particularly acute in developing countries, where companies that operate informally produce as much as 80 percent of the output in some industries. By avoiding taxes and regulatory obligations, informal companies gain a substantial cost advantage that allows them to stay in business despite their small scale and low productivity. This prevents more productive, formal companies from gaining market share. The result is slower economic growth and job creation.

Below is a table comparing the costs and benefits of formal and informal institutions for small business development. Similar tables will be developed for discussion regarding the other three thematic areas.

	Costs	Benefits
Formality	<ul style="list-style-type: none"> • Administrative Permits • Taxes • Products Regulations • Labor Regulations 	<ul style="list-style-type: none"> • Limited liability • Shielding the firms assets form shareholders' creditors • Enforceable rules and agreements among partners • Predictable rules to withdraw capital from the firm • The possibility of issuing shares that facilitate the perpetual succession of the firm, can be used to raise capital, transmit information about the business and represent rights over the enterprise • Access to business identification mechanisms that transmit information about national identity, addresses, the assets they own, their financial history, etc. • Access to rules that establish enforceable standards of responsibility among partners, administrators and workers, allowing a more efficient division and specialization of labor and achieving economies of scale • Enforceable contracts • Access to formal conflict resolution mechanisms • Legally advertise and protection of brands and trademarks • Predictable and speedy rules for closing a business • Default rules • Membership of trade associations • Permits to use public land, resources and utilities • Access to incentives packages such as tax rebates, exports licenses and trade fairs • Flexibility
Informality	<ul style="list-style-type: none"> • Fewer mechanisms for dealing with risk and uncertainty • Bribes and corruption • Lack of identity • Limited access to economies of scale and scope (markets are limited to family circles) • Impossibility of diversifying risk and investments • Higher transport costs • Risk of losing family assets • Less access to market knowledge • Difficulty to establish business hierarchies different from the family ones • Difficulty to divide and specialize labor • Enforcing contracts only by force • Limited access to capital • Short-term firms and investment • Less incentives to invest in human capital • Losing the advantages of advertising because they have to hide their business • Unpredictability (inspections, laws, etc) • Higher credit costs 	<ul style="list-style-type: none"> • Avoiding the costs of formality (taxes, permits, regulations)

Table developed by some participants of the Commission's Working Groups.



Relation to Development Co-Operation

Enhancing the affective allocation of internal resources - including the release of “dead capital” - does not require increased aid, but rather the re-ordering of spending priorities and the re-invention of delivery mechanisms. In terms of policy and program development, it means understanding the assets of a country differently, and initiating policy and program development from an assets rather than a needs base, focusing aid in the first instance on releasing dead capital through development of processes and legal frameworks for capital formation tailored to the circumstances of the poor.

The process might be set back by increasing aid, which would allow policy makers to deliver the low hanging “development fruits” while avoiding the institutional transformation required for wealth creation. On the other hand, increased aid could become a catalyst for movement in the right direction by building on some of the more recent aid effectiveness principles, such as good governance, local ownership, harmonization and alignment.

In the final analysis, the key determinant of the impact of increased aid on informal institutions or on development through informal institutions is, of course, the local reality – social, political and economic.

Policies and programs should be designed to promote convergence between formal and informal institutions by identifying and working on the informal aspects of the formal institutions and the successful aspects of the informal. This would provide the foundation of a more inclusive market democracy as the basis for poverty reduction, wealth creation and human freedoms.