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The Size of the Informal Economy in Venezuela

Abstract

Informality is a worldwide phenomenon with special prevalence in developing countries. In Venezuela, informality has experienced a rapid growth since the eighties, reaching its peak in 2003. In fact, a significant part of productive activities are informal, with informal employment sometimes exceeding the formal one, generating distortions in the economy. In an attempt to understand the informal economy in Venezuela this study revises some theoretical aspects of the informal sector, such as causes and consequences. The article also quantifies the size of the informal sector and compares different calculation methods and data. Findings indicate that the sector is characterized by a high prevalence of women over men; relatively older and unskilled workers; and low levels of investment, organization and productivity. The informal economy's contribution is one fourth of the non-oil real GDP, and it employs a significant part of the working population.

Keywords: informal economy, monetary methods, physical input method, Venezuelan labor market.

1. Introduction

Informality is an increasing world-wide phenomenon. In the OECD, the size of the informal sector went from 13.2% of GDP in 1990 to 16.7% in year 2000. In Latin America, this sector increased from 47.5% of the GDP in year 1990 to 50.3% in 2005 (Tokman, 2007). Among them, Venezuela has experienced a considerable expansion of the informal economy, which has even employed more than 50% of the total active labor force. This papers attempts to quantify the magnitude of this sector with respect to the non-oil real GDP in Venezuela.

As it can be seen from table 1, for the period 1999-2000 regions may be classified in two different groups in terms of the size of informal sector as a percent of GDP: on one hand, African countries with an average of 42%, and about the same percentage in Latin America. On the other hand, Asian countries (26%) and OECD countries (18.0% and 13.5%), conforming the group for which the informal sector has a much lower weight in the economy.

TABLE 1. Size of the Informal Economy as Percentage of GDP (1999/2000)			
Region	Minimum	Average	Maximum
North America and Pacific OECD	8.8	13.5	16.4
West Europe OECD	8.8	18.0	27.0
Asia	11.3	26.0	52.6
Latin America	19.8	41.0	67.1
Africa	28.4	42.0	58.3

Source: Friedrich Schneider, 2002. Size and Measurement of the Informal Economy in 110 countries around the world. Workshop of Australian National Tax Center, Australia

Since 1972, when Keith Hart expressed his concern about those productive activities considered as marginal, not because they were illegal but because of the characteristics and behavior of individuals involved in it, many researchers have paid attention to this situation, developing different approaches, and therefore ways to define and measure it.

The first definitions of informality included terms such as poverty, marginality and under-employment. However, posterior approaches considered this phenomenon related to economic activities performed without fulfilling law requirements (Hirschman 1970, Mincer 1976, De Soto 1987). Feige (1990) defines as informal the following activities: production of goods and services forbidden by law (illegal activities); activities not included in National Accounting (unregistered activities); activities undertaken under tax evasion (undeclared activities), and legal activities undertaken outside laws and rules. In 1993, the International Conference of Labor Statisticians (ICLS) defined the informal sector as all unregistered enterprises below a certain size, including micro enterprises owned by informal employers, and own account operations owned by individuals who may employ contributing family workers and employees on an occasional basis (ILO 1993). Based on that, in 2003 the ICLS expanded the concept of informal employment to include employers in informal enterprises, own account workers in informal enterprises, unpaid family workers, and members of informal producers' cooperatives.

According to the modern view, the informal economy is a major provider of employment, goods and services for lower income groups, mostly due to the decline in formal employment. The informal economy is made up of a wide range of informal occupations, such as casual labor in construction and agriculture, temporary and part time jobs plus homework for high tech industries. It includes non standard wage workers as well as entrepreneurs and self employed persons producing legal goods and services, through irregular or unregulated means.

Regardless its definition, the general literature characterizes the informal sector as follow: no or low control by government; own-accounted or family small enterprises whose owners get involved in their activities; small production units, with no distinction between capital and labor as factors of production; labor-intensive production processes and obsolete or poor technology; lack of barriers to the entry; inefficiency as well as low human and physical capital investment (Tokman, 1982); unskilled workers, most of them young and women, although that is not always the rule; job

flexibility, with formal or informal contracts of employment; non competitive and non ruled markets (Klein and Tokman, 1988) and preference for cash transactions.

It is not clear whether the informal activity can be considered as a problem or a solution, or even how long it will last. For some, it can encourage tax evasion, illegal competition and corruption, and therefore being harmful for the economy, and will eventually disappear with modern economy. For others, the informal activity is made up mostly of survival activities, and can be considered as an escape for workers who cannot find a job in the formal sector. The reasons and the consequences of informality also vary according to the different theories devoted to its study: the dualist, the structuralist, the legalist, and the illegalist (Women in Informal Employment: Globalizing and Organizing, WIEGO, 2008).

It can be concluded therefore that the definition of informality has been evolving, to try to account for different and new situations faced by the economies. But still differences persist, which explains the different school of thought, whose characteristics are summarized as follows:

TABLE 2: Schools of Informality Scholarship		
School of thought	Characteristics	Authors and References
Dualist	<ul style="list-style-type: none"> The informal sector is comprised of marginal activities, not related to the formal sector, that provide income for the poor and a safety net in times of crisis. The persistence of informal activities is due to the fact that not enough modern job opportunities have been created to absorb surplus labor, due to a slow rate of economic growth and a faster rate of population growth. 	ILO, 1972 Sethuraman, 1976 Tokman, 1978
Structuralist	<ul style="list-style-type: none"> The informal sector should be seen as subordinated economic units and workers that serve to reduce labour costs and increase the competitiveness of large capitalist firms. Different modes and forms of production coexist; they are connected and interdependent. The nature of capitalist development, rather than a lack of growth, accounts for the persistence and growth of informal production relationships. 	Moser, C., 1978 Castell and Portes, 1989
Legalist	<ul style="list-style-type: none"> The informal sector is comprised of micro-entrepreneurs who choose to operate informally in order to avoid the costs, time and effort of formal registration. Micro-entrepreneurs will continue to produce informally as long as government procedures and regulations are cumbersome and costly. 	De Soto, H., 1989, 2000
Illegalist	<ul style="list-style-type: none"> The informal economy is an underground or black economy. Informal entrepreneurs operate illegally to avoiding taxation, commercial regulations, electricity and rental fees, and other costs of operating formally. In some cases, they deal with illegal goods and services. 	Maloney 2004
Sources: a) Chen, Martha, Joann Vanek and Marilyn Carr. 2004. Mainstreaming Employment and Gender in Poverty Reduction: A Handbook for Policy-makers and Other Stakeholders, London: Commonwealth Secretariat. b) International Labour Organization (ILO). Resolutions Concerning Statistics of Employment in the Informal Sector Adopted by the 15th International Conference of Labour Statisticians, January 1993		

In Venezuela, the Central Bank considers as informal all those activities not officially registered in the National Accounting. This is the definition used in this study.

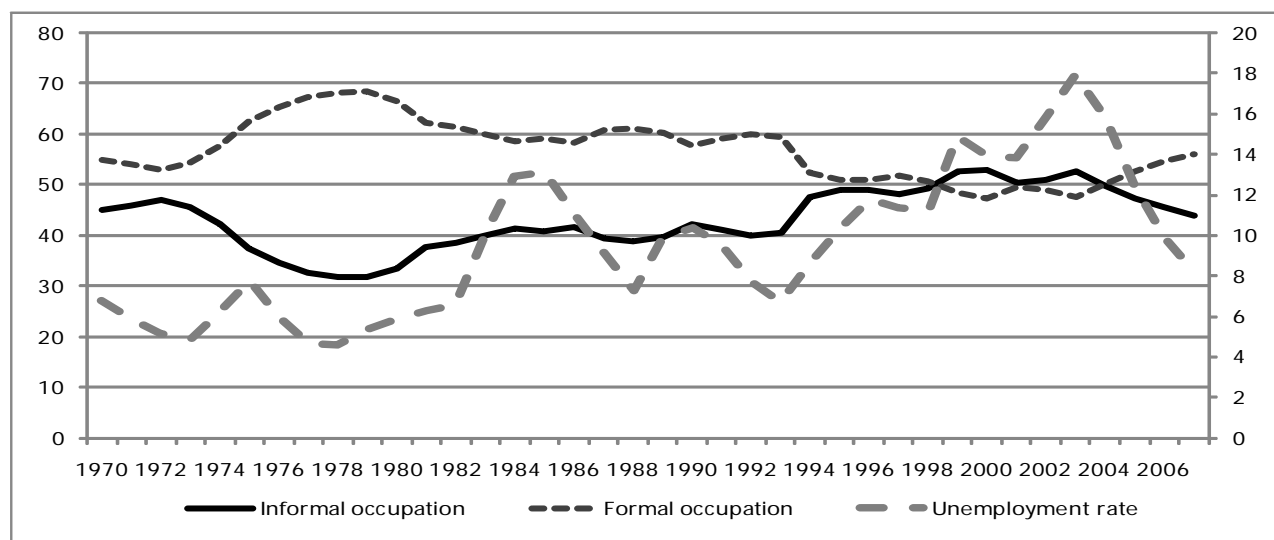
This paper briefly revises the nature of the informality in Venezuela, its reasons and consequences for the economy, as well as estimates its magnitude through different methods. The results suggest that the informal activity is equivalent to about a fourth of the non-oil real GDP, but may employ more workers than the formal economy.

2. Informality in Venezuela: Characteristics, Reasons and Consequences

2.1. General Characteristics

Informality in Venezuela is characterized by an increasing participation of the active labor force (over 40%), being 1985, 1990, 1996 and 2003 the most critical years when, as expected, the unemployment rate reached its highest levels too: 13.1%, 10.4%, 14.9% and 17.9%, respectively (see figure 1). It is important to highlight that both unemployment and informal employment declined after year 2003, in spite of the national strike between late 2002 and beginning of 2003 that ended up with the firing of more than 15,000 employees of the national oil company PDVSA. The explanation for such a decline can be found in the programs implemented by the government called “missions”, that provide financial support to individuals who participate in them, discouraging the search for a job, and therefore reducing the active labor force.

Figure 1. Unemployment, Formal and Informal Occupation in Venezuela 1970-2007 (%)



Source: Household Survey.

Informal workers are mostly self-employed whose activities are not registered, with low levels of education (6 years average) even though that is not always the case since graduate workers in this sector are not rare; on average a few years older than those in the formal economy, unlike the general characterization; with a higher and increasing women participation (from 37.4% in 1993 to 54.2% in 2003), although male participation has also increased through the years, but a lower rate. After year 2003, both rates declined, especially among men¹.

¹ However, by 2006 male participation in the informal economy exceeded the female one (43.9% versus 41.2%).

As said before, the informal enterprises usually show low levels of production, productivity and capital investment. That is probably why most of them are related to commercial or mercantile activities (over 30%), followed by services (over 20%) and agriculture (above 15%). The average income in the sector is lower than the one in the formal economy, with no significant differences based on level of education, but with a notorious gender difference: men tend to gain 70% more than women.

2.2 Causes

The general literature attributes the phenomenon of informality to different factors: the effects of globalization and increasing trend to unregulated markets on workers' rights (Rosales, 2003); incapacity of labor market to absorb the increasing labor force resulting from natural population growth and migration, such a rigidity pushes discouraged and desperate workers to the informal sector (Mejía and Posada, 2007); the preference for reducing or avoiding the paper work and costs (including taxes) associated to creating and ruling a formal enterprise; unclear laws and rules providing a discretionary power to public agents, promoting bureaucracy and corruption, and discouraging formal activity; economic crises.

In Venezuela, there are three main reasons to blame for the expansion of informal activities: market rigidity, regulations and economic crisis. Regarding the first one, as shown in figure 1, informal employment shows its highest values at the same years as unemployment rate (the correlation between these two variables for the period 1990-2007 is 72.3%). The higher unemployment was the consequence of an economic crisis that started with the oil boom in the late seventies and induced a strong devaluation in the early eighties, which also generated a long recession and economic instability for over a decade. Since the national strike against president Chavez's policies in 2002, when most of the PDVSA workers were fired, many private industries has closed or has been expropriated by government, which contributes to the informal activity.

Regarding regulations, either the lack or excess of them can be associated to the informality. It is known that the more the bureaucracy, the more the incentives to avoid it and therefore to lower the costs of starting an economic activity. According to Doing Business (World Bank, 2006), it takes 13 steps and 116 days on average to register a new firm in Venezuela, numbers that are above the Latin America average (11 and 70, respectively) and far away from the OECD's (6 steps and 25 days). Besides, since informal enterprises are not registered, they do not pay taxes, which reduces their costs. Laws ruling labor markets also may induce the informal activity: costly and unsustainable lump sum retirement payments forced by law; wage setting system; fringe benefits such as insurance, paid vacation, paid sick leave, over-time, etc. In Venezuela all these aspects of the job package are determined by government, with every time less participation of the private sector, increasing the costs of hiring workers and lowering the labor demand.

2.3 Consequences

Regarding the worker, there is no doubt that the main consequence of informality is that workers in this sector do not enjoy the social benefits provided by an employer and required by law,² as well as other benefits such as Unemployment Insurance³ and housing benefits⁴ or access to credits to expand their activities. In other words, they are not protected by national labor laws. Also, given the

2 In Venezuela, access to the social security system and state pension plans must be provided by an employer.

3 This program is financed with contributions from workers based on their wages, and intended only for workers who eventually lose their jobs.

4 Monthly wage deduction to finance housing construction. Only those who contribute to this may enjoy its benefits.

characteristics of the informal activity, income in this sector is lower compared to similar formal activities, with no job stability, which deepens income inequalities.⁵

For government, the main consequence of informality is taxation revenue loss, since such undeclared activities do not pay taxes. Quantifying the magnitude of this loss implies measuring the size of the sector, which is not easy and accurate.⁶ A gross estimation indicates that in 2006 this loss was of \$17.4 million. Also, due to informality macroeconomic indicators can be misleading for policy design and evaluation.

For the economy and the society as a whole, informality implies a dishonest competition for comparable activities in both sectors, inefficient use of factors of production, and a door for social problems such as drug dealing, high-school dropouts, unauthorized use of public spaces and services (illegal power and water connections), health problems, inadequate garbage disposal, traffic congestion, etc.

3. Estimation Methods of the Informal Sector

Quantifying informality is one of the hottest topics in labor economics in Latin America since late seventies. Several approaches have been developed, but yet an accurate one does not exist, given the difficulties faced when trying to collect the data or to consider all the possible factors involved.

There are direct and indirect methods to measure the magnitude of the informal sector. Direct methods are based on surveys conducted on a random sample of household enterprises or of employers and employees, asking for their formal or informal condition and income generated for their activities. As usual, the disadvantage of this approach is that it relies on their willingness to participate in the survey and the degree of honesty of their answers.

Indirect methods estimate the size of informality by tracking down their footmarks through the economic activity (Chapa, Flores y Valero, 2007). They can be macro-model methods (monetary methods, global indicator methods and latent variable methods) or national accounts methods. Among the monetary methods, the most common ones are the transaction method (Feige, 1979); cash/deposit ratio approach (Guttman, 1977) and cash demand approach (Tanzi, 1982). A commonly used global indicator method is the physical input or electricity demand approach (Kaufmann and Kaliberda, 1996). Other indirect methods for measuring informality are the labor input method, commodity flows approach, among others. Based on data availability, this study compares the results obtained by the cash/deposit ratio, cash demand and physical input methods with those obtained by a direct one.⁷

3.1. Cash/Deposit Ratio Method

As any other transaction method, this approach assumes that all transactions in the informal sector use only cash, which facilitates tax evasion and norms violation. The measure of the magnitude of the informal activity is therefore given by:

5 According to the Economic Commission for Latin American and the Caribbean (ECLAC), by year 2004 the Gini coefficient for Venezuela was 0.470.

6 Next section presents some attempts for measuring the magnitude of informal activity in Venezuela.

7 The transaction method, based on the assumption that there exist a long run relationship between GDP and volume of monetary transactions, was also applied. However, the results obtained were not clear, probably due to the difficulty of satisfying the original condition of using a year with zero informality as a benchmark.

$$\frac{Y_i}{Y_0} = \frac{C_i}{C_0 + D} \tag{1}$$

Where Y_i and C_i represent informal sector total production and total cash used, respectively; Y_0 and C_0 represent formal sector total production and total cash used, and D stays for deposit demand. Equation (1) assumes that both sectors use the same proportion of cash, which is compared with a based year with zero informality, which are the main disadvantages of this method. Hanousek and Palda (2003) propose a modification of the previous equation in order to account for different patterns of cash usage in both sectors:

$$Y_i = Y_0 * \frac{C - (k_0 * D)}{D + (k_0 * D)} \tag{2}$$

Where C is total cash used in the economy, with no distinctions between sectors. k_0 stays for the formal economy cash/ deposits proportion under zero informality. It is easy to see that with $Y_i=0$

$$k_0 = \frac{(Y_0 * C)}{(Y_0 * D)} = \frac{C}{D} \tag{3}$$

Once k_0 is obtained, it is assumed constant over time, and (2) can be estimated. In order to apply this method to the case of Venezuela, using data from the Central Bank (BCV), some considerations needed to be made. First of all, since it is not possible to find a year with zero informality, instead we used year 1980, when informality showed its lowest level, probably due to the economic boom resulting from oil activity. Second, given the importance of the oil activity in Venezuelan economy, this sector is not included in Y_0 , which makes sense since it is assumed that there is no informality in the oil industry. The results indicate that the size of informality averaged 4.29% of the non-oil GDP during the years 1980-2007, with a standard deviation of 0.517.⁸

TABLE 3. Informality Estimates			
Method	Size of informality (% non-oil real GDP 1997)		
	Average	2005	2007
Cash/demand ratio	4,29	-	-
Cash demand	-	17.38	28.15
Physical input	17.70	19.64	21.93
Direct method	29.43	25.31	21.48

Source: Own estimates

This small proportion may be explained by the lack of efficiency and low productivity of the sector. However, the fact that, as we will shown, they substantially differ from those obtained from other

⁸ For a summary of the results obtained from all the methods applied, see table 1

methods, indicates that this result is probably due to the impossibility of satisfying the assumptions established by this approach.

3.2 Cash Demand Approach

According to Tanzi (1982), one of the main reasons for informality is tax evasion and government regulations. Because of this, and given the weaknesses of the cash/deposit ratio approach, he proposed the estimation of a cash preference function, considering as explanatory variables not only the traditional ones used when studying money demand, but also tax burden:

$$C/M2_t = \beta_1 + \beta_2 T_t + \beta_3 W_t + \beta_4 Y_t + \beta_5 R_t + \varepsilon_t \quad (4)$$

Where $C/M2_t$ is the average cash used in the economy at period t ;⁹ T_t is a proxy for tax burden;¹⁰ W_t indicates aggregate wages as part of national income; Y_t is per capita national income; R_t is the passive interest rate and ε_t is an error term $N(0, \sigma^2)$. Variables are expressed in logarithm terms in order to get elasticity. We should expect T to have a positive impact on the dependent variable, since the higher the regulations and taxes the more the incentives to informality. As for the other variables, it is easy to understand that they should have a negative impact on $C/M2$.

Equation (4) is estimated with and without¹¹ tax burden (T), in order to figure out the impact of such a burden on cash demand. The difference between the two equations is assumed to be cash demand for informal purposes, or informal cash. Multiplying the informal cash by velocity of circulation of money, the magnitude of the informal product is obtained. As before, for the case of Venezuela we considered the non-oil per capita GDP.

The results indicate that the informal activity were about 17.38% of the non-oil real GDP in year 2005, increasing up to 28.15% in year 2007. However, the fact that for some years this percentage is negative may indicate inconsistencies that can be explained by an inadequate estimation of the tax burden, or the inappropriateness of the assumption of equal money circulation velocity in both formal and informal sector.

3.3 Physical Input

This method, initially proposed by Lizzeri in 1979 and modified by Kauffman and Kaliberda in 1996, relates electricity demand and GDP, under the assumption that such a relation is stable over time. The electricity consumption unexplained by GDP is attributed to the informal economy, specifically to own-accounted or family small enterprises. The average electricity demand/GDP ratio is obtained for a given period and then applied to the yearly electricity demand to obtain what is called the theoretical GDP. The difference between this theoretical GDP and the actual GDP is an estimation of the magnitude of the informal economy.¹²

9 For the purpose of this study we used the M1/M2 ratio as the dependent variable. For the period considered, this ratio averaged 44%, with an increasing trend in the last years when even passed over the 50%. This indicates a monetization process.

10 For the case of Venezuela, T includes non-oil direct and indirect taxes. We should also have considered other fiscal contributions such as Housing Benefits, Social Security, and unemployment insurance, for the information was not always available.

11 Estimating equation (4) without T is the same as assuming that there are no incentives for informality (no taxes, no regulations).

12 Even though this method is widely used, it is also true that the difference between the two GDPs may be due to factors others than informality, such as the introduction of cutting edge technology.

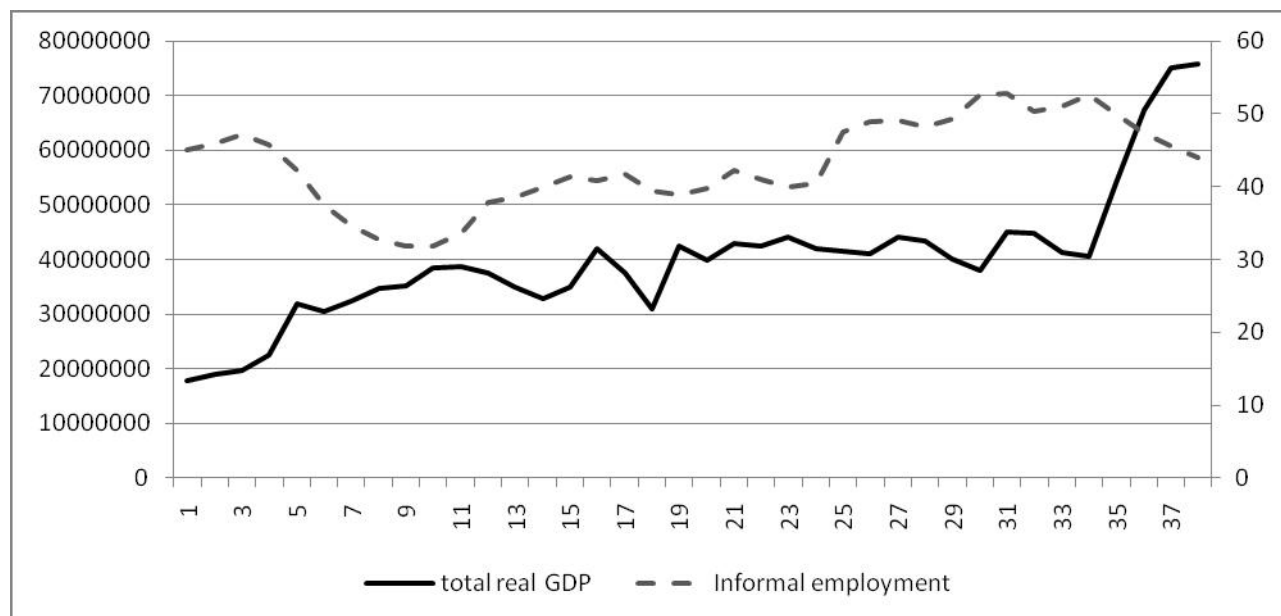
For the case of Venezuela, we used the 1993-1996 period to estimate the average electricity demand/GDP ratio, which was 0.127. During this period, the economy was relatively stable, in spite of a financial crisis in 1994, especially compared to the eighties when all macroeconomic indicators showed strong fluctuations. According to this method, on average the informal activity was 17.70% of the non-oil real GDP during the period under study, with a standard deviation of 4.09. For year 2007 this percentage was about 21.93%, similar to the value estimated with previous methods.

3.4 Direct Method

The general perception is that in Venezuela, informality is a consequence of the adverse behavior of macroeconomics indicators resulting, basically, from the high dependence and volatility of the oil market. As can be seen in figure 2, years with high total GDP are associated to low levels of informal employment, especially years 2002 and 2003, when more than 50% of the workers were employed at the informal sector..

A direct estimation of the size of the informal economy can be obtained by multiplying the number of informal workers times their average income, based on the information provided by the Household Survey, conducted twice a year¹³. According to this, the informal sector was 25.31% and 21.48% of the non-oil real GDP in years 2005 and 2007, respectively. Estimates of previous years indicate that this percentage was above 34% in years 2002 and 2003, averaging 29.43% during the period under study. The results are consistent with those obtained by the physical input and cash demand approaches.

Figure 2. Total Real GDP (MMBs) and Informal Employment (%)



Source: Household Survey.

¹³ Information regarding informal condition of the worker is available only since 2005.

4. Conclusions

Informality is basically referred to activities performed without satisfying law requirements, which does not imply they are illegal, and not officially registered in National Accounts. This is what the Venezuelan Central Bank defines as informal activity. In Venezuela, informal sector has employed a proportion of workers that has even overpassed the 50% of the workers. However, its contribution to the total GDP, excluding oil activities to avoid distortions, is far from that, due to the low productivity that characterizes this sector. Also, there is a high prevalence of women over men, relatively older workers and a generalized low level of education. Consequently, informal activities in general are inefficient and associated to poor technology and low levels of production.

Even though a voluntary informal employment may exist (especially to avoid government regulation and taxes, the majority of the workers moves to this sector due to the labor market inability to absorb them as the consequence of political and economic circumstances. As the result of it, workers in this sector are not protected by labor laws; do not have access to credit to expand their business and receive an income that is generally much lower than a similar worker would receive in the formal sector. Besides, macroeconomic indicators may be misleading since they do not account for this sector, not to say about tax evasion.

That is the main reason for trying to quantify the magnitude of this sector. This paper estimated informality as a percentage of the non-oil real GDP through four methods: cash/deposit ratio, cash demand, physical input and direct methods. The reason for not considering total GDP is the relatively high importance of the oil industry in Venezuela's economy and the fact that informality does not exist in that sector.

Among the approaches considered, the results of the cash/deposit ratio are much smaller than those obtained by the others. This could be due to the difficulties to satisfy assumptions such as finding a starting point given by a year with zero informality. Therefore, according to the cash/deposit ratio approach, informality on average was less than 5% of the non-oil real GDP during the period under study (1983-2007).

Regarding the cash demand approach, it also presented inconsistent results, negative for some years, probably explained by the difficulties of finding an appropriate estimate of the fiscal or tax burden. In spite of it, according to this method informality was 28.15% of the non-oil real GDP for year 2007. Less restrictive, the electricity demand method estimates that for that same year informality was about 21.9%, averaging about 18% for the whole period. These results are quite similar to those obtained by the direct method, where average informal income is multiplied by the number of workers in this sector, based on information provided by the National Survey. In fact, according to this approach informality was 21.5% of non-oil real GDP at year 2007, averaging near 30% during the period under study.

Regardless of the approach used, the general results indicate that informality is responsible for the equivalent of about a fourth of the non-oil gross domestic product, employing near a half of the total working population. This is a clear indication of the magnitude of the problem in Venezuela as well as of the low productivity of this sector.

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