

High Level Commission on Legal Empowerment of the Poor (HLCLEP):

Overview Paper

Executive Summary

The High Level Commission on Legal Empowerment of the Poor seeks to explore how nations can reduce poverty through reforms that expand access to legal protection and economic opportunities for all.

Today, most of the world's poor live in the informal economy, occupying land they do not own, working in small, informal businesses, and relying on friends for loans. They often have limited access to broader economic opportunities and are especially vulnerable to the uncertainties, the corruption and even violence prevalent outside the rule of law. The Commission recognizes the important correlation between poverty and informality and the critical need to address structural injustices, so that all citizens can be empowered to reap the benefits of a globalizing economy.

Despite the important efforts of experts and development institutions in recent decades to implement programs and reforms aimed at expanding formal property and other rights, there have been few successes to date. Today it is widely recognized that reducing informality requires a series of complex, in-depth policy initiatives and structural reforms that create real incentives for governments, institutions, and individuals, and ultimately improves the capacity of national and local governments to generate sustainable growth. Reforms will only be effective if they are based on empirical evidence of practices in the informal economy, and are developed with a clear understanding of local environments and ownership systems, and, perhaps most importantly, with the active participation of those whom policy initiatives are meant to assist. Efforts to reverse the expansion of informality must also contribute to the legitimacy and legality of institutions, to an environment where rights are enforceable, and to a deepening of local financial capacity where lenders have incentives to expand access to credit for households and micro, small and medium-sized enterprises.

Global leaders from developed and developing countries are now converging around the idea that extending legal protections and property rights holds unrealized potential for economic poverty reduction and long term sustainable development, but they seek an organized and consensus-based approach within the development community to unlocking that potential. There is a need to compare and synthesize lessons learned across global experience and among different institutions, to identify promising reform paths and tools, and to use these experiences to influence real outcomes on the ground.

This paper offers a broad overview of issues that are critical to any discussion of reforms around legal protection. It is neither exhaustive nor definitive. Rather, it offers top-line

insights on informality, and its link to poverty, drawn from global reform programs and other research. It also provides context to facilitate and focus the discussion on some of the complex questions the Commission faces at the outset of its mandate:

- What specific reforms are most effective in addressing each major dimension of informality? How does the context of reforms impact their success?
- How can existing practices provide a blueprint for the design of reforms?
- What incentives are required to encourage migration to the formal sector?
- What is the most effective sequencing of reforms? How does context impact the sequencing of reforms?
- What negative and/or unintended consequences are experienced in existing formalization initiatives? How can such impacts be prevented or mitigated in the implementation of reforms?

1. Introduction

1.1 HLCLEP's mission

The stated aim of the High Level Commission on Legal Empowerment of the Poor (HLCLEP, “the Commission”) is to explore how nations can reduce poverty through reforms that expand access to legal protection and economic opportunities for all. Poverty eradication is central to the set of eight inter-connected Millennium Development Goals (MDGs) to which all members of the United Nations agreed in September 2000. Member nations also agreed to put in place programs and policy initiatives that are aimed at cutting extreme poverty globally in half by 2015.

The Commission is based on the conviction that poverty can only be eradicated if governments give all citizens, especially the poor, a legitimate stake in the economy, thus making it the right of all citizens, and not the privilege of a few, to have access to user and property rights and other legal protections.

Today, by contrast, most of the world's poor live day-to-day outside the law in the so-called informal or extralegal sector. They may occupy land they do not own, work in underground businesses, rely on friends for loans, and have few means to settle disputes apart from bribery or violence. Without legal rights or protections, they are in a continual state of legal and political vulnerability. Informality, then, limits the opportunity for economic and social development for individuals, families, businesses, communities, and entire nations (see Section 1.3).

It is a complex proposition, however, to design reforms that can encourage a migration to the formal sector. Some observers rightly fear that challenging informality will bring unintended and undesirable consequences, which can arise when the status quo is disturbed. They note, for example, that some attempts to reform property rights have only further undermined the poor, rather than empowered them.

However, even failed reforms offer scant reason to question the merits of the opportunities furnished through access to formal legal rights. Rather, they compel reformers to make sure that any attempts to encourage a migration toward formality address the complex interrelated social, financial, legal and political issues, policies, and customs that will be affected by making the illegal legal.

Accordingly, the Commission plans to draw on a broad range of empirical studies and country experiences to develop recommendations, tools and initiatives that can guide policymakers' reform efforts at the country level.

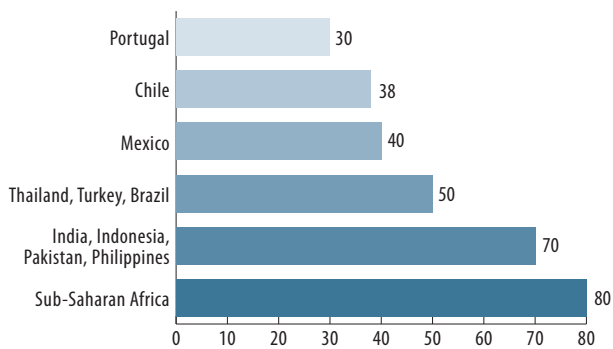
Time and again, studies show that the poor make highly rational choices in attempts to better their position. Informality may be a rational choice, given the available options, but it is often a costly (both in terms of actual costs and opportunities foregone) and negatively defined response. It is the job of reformers to turn formality itself into a viable and attractive option for the poor.

1.2 Purpose of the overview paper

There are a variety of strategies that countries, multilateral organizations and development experts have taken to address the challenge of legal empowerment. By studying a representative sample of these experiences, the Commission can identify promising reform paths and tools, with the aim of influencing real outcomes on the ground.

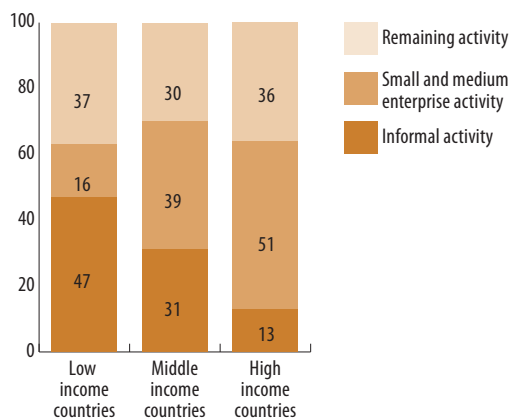
Figure 1.1
Informality thrives in poorer countries, and stifles SMEs

Estimated share of nonagricultural workforce that is informal



Source: World Bank and International Labour Organization

Percentage of GDP



Source: Ayyagari, Beck and Demircuc-Kunt (2003)

This paper offers a broad overview of issues that are critical to any discussion of reforms around legal protection as it relates to opportunities for the poor. It is neither exhaustive nor definitive. Rather, it offers top-line insights on informality and its link to poverty, drawn from global reform programs and varied research sources. This overview is meant to be an initial “primer” to the Commission’s discussion and to facilitate the development of a more specific work program.

Key issues covered in this paper include:

- The importance, causes, scope, and magnitude of informality
- The consequences of informality, especially the real and opportunity costs of informal land rights, meager access to credit, and inadequate contract enforcement
- The social impact of informality
- Approaches and lessons learned from attempts to promote formality and the associated capabilities among international agencies

1.3 Addressing informality

Informality characterizes those activities or holdings of land of households and businesses that lack formal (legal) recognition. Informality manifests itself in many ways but especially in the ownership of land, housing, and other property, in the provision of labor and other services, and in the management of finances and assets. Informal activities may be illegal or, more typically, simply unrecognized by law or regulation, though many are tolerated, creating an ambiguity that can complicate reform strategies.

Formalization is the process by which informal activities, participants, and entities obtain legal recognition. It must often be supplemented, or preceded, by a variety of substantive reforms, including changes in commercial or property law, the recognition of customary or religious laws, and improvements in the mechanisms to enforce rights and adjudicate disputes. It must be based on empirical evidence of practices in the informal economy and developed with a clear understanding of local environments, systems, and needs.

The Commission’s work is based on the assumption that the process of extending formal legal rights and protections to marginalized groups can contribute to strengthening governance and institutions and the promotion of sustainable growth and development, thus alleviating poverty and reducing instability. This conviction is built on some compelling realities.

Despite the fact that informality is a complex phenomenon and causalities are often difficult to prove (see Section 2), it is clear that informality foments poverty. In poorer countries, the informal sector thrives and often dwarfs the formal economy, and informal economies lack the healthy core of small and medium-sized enterprises that have proven to be critical

engines of economic growth in wealthy nations (see Figure 1.1). Migration to the formal sector, by contrast, is correlated with the lessening of constraints on economic growth, revenues, and increases in investments in health, education and infrastructure. Those countries that show strong, sustained growth rates are countries in which the formal sector is expanding.

Addressing informality is a multifaceted proposition which requires a thorough understanding of the factors that create and drive informality (see Section 2). Reform initiatives may also require that the formal sector be re-defined to accommodate many of the principles and values tolerated in the informal sector - and upon which legitimacy has been implicitly conferred.

Clearly, there is no single approach to reform. The fundamental challenge for the Commission will be to frame an incentive-based strategy that takes into account the complexity of the legal, social, cultural, political, and economic dimensions of informality — a strategy that is both bottom up and top down, fully reflecting the objectives, priorities, and concerns of the poor; a strategy that is transparent, broadly owned, and supported by an approach to effective implementation.

2. Informality: concept, causes and magnitude

2.1 Concepts, types of informality

The world's poor operate in or interact with the informal sector daily. Informality in developing countries manifests itself in one or more of the following forms:

Land and housing ownership. Within the sphere of land ownership, informality is often equated with lack of title. For example, at least one-quarter of urban residents in Latin America are either squatting or living in unauthorized housing. However, other forms of legitimate ownership exist, including customary tenure, which is typical in much of Africa. Customary tenure may or may not be outside the realm of law, but traditionally it has bestowed a relatively high level of tenure security and property rights, similar to those offered by individual freehold titles.

Businesses and services. While large enterprises typically operate in the formal economy even in developing nations, small and medium-sized enterprises are marginal in the formal economy. Informal SMEs lack access to bank financing and long-term capital, so their activities remain subscale. These businesses are unregistered, do not pay taxes, and do not have legally binding contracts.

Labor informality. Labor is the other ubiquitous form of informality in developing nations. Recent work by The Institute for Liberty and Democracy (ILD) in Egypt, for example, concluded that the country's large extra-legal economy employs more than 8 million people, or about 40% of the total work force. The informal work force itself is comprised by many constituents, including migrant, seasonal, and temporary workers, sub-contractors, home-based and micro-enterprises, but these workers — many of which are women — all lack adequate representation and protection, and they endure sub-standard pay and working conditions. A large proportion of women end up as informal laborers out of necessity — working in sectors from farming to prostitution.

2.2 Causes and contexts

In order to understand what creates and sustains informality, it is vital to understand why individuals and populations live in the informal economy. Are individuals and businesses explicitly and deliberately excluded from the formal economy, and if so, is that exclusion the result of legal, economic, societal, or other pressures? Do participants themselves opt to reject the formal economy, and, if so, why? Are the barriers to entry too high; is scaling these barriers too costly? Do migrants to the formal economy actually become disadvantaged by the move, at least in the short term? What is the role of the legal order in this process? In short, what prompts participants to remain in, or to step outside, legality?

Evidence suggests that a variety of factors contributes to the existence and growth of informality, including:

- **Rural migration to urban areas.** Urban populations are growing unsustainably as migrant opportunity-seekers flood to peri-urban areas with poor housing conditions and almost no urban infrastructure. Many of these laborers cannot find formal employment. For example, following decades of intensive migration, more than 60% of Sao Paulo's residents live informally. In the process, they have occupied most of the city's water reservoirs and other environmentally protected areas.

- **Regulations and burdensome legal codes.** Informality — in access to land and in business — thrives when entry to, and participation in, the formal sector is complex and expensive. For example, it is typically a long and expensive proposition to register a business in a developing country. The World Bank’s Doing Business database shows it took ten procedures, 96 days and 1,442.5% of annual income per capita in fees to open a business in Zimbabwe in 2005. Moreover, even minimum capital requirements typically exceed the resources at the disposal of many in developing nations. Also, planning laws tend to be elitist and technocratic, failing to recognize both the socio-economic realities determining the conditions of access to land and housing and the limited capacity that local government has to enforce the legal provisions.
- **The tax burden in the formal economy** makes it preferable for small firms to operate informally, where savings from tax avoidance enable them to charge less and increase revenues and profits. Moreover, the tax burden often rises when informality is pervasive. Where informality is high, the paucity of legal registrants — whether for businesses or land titles — tends to raise the burden on those that do register.
- **Political capital and “connections”** are often needed to help guide participants through the maze of bureaucracy in a reasonable timeframe, thus fomenting a culture of political elitism and corruption.
- **Historical customs and practices** can contribute to insecurity of land tenure. For example, there are many forms of customary tenure, and the lack of recognition by national law can create serious insecurity, especially at the interface between customary and statutory land tenure in peri-urban areas.
- **National policies** may disrupt the free market for labor. For example, many developing economies put controls on labor practices, which, while meant to be a source of protection, effectively hinder hiring and firing and restrict the opportunities for formal employment.
- **Inadequate depth of financial sector development** (loans, bank accounts, insurance). In many developing countries, mortgage laws are weak and banks are reluctant to finance small players — especially those without titles and other legal assets that can be used as collateral. Banks also rarely provide financial services to the poor, who are thus forced to find informal mechanisms for storing assets and finding investment opportunities whether pawn-shops or unscrupulous money lenders.
- **Weak judicial systems** exacerbate all of these problems. The poor generally expect little recourse from the slow, corrupt, and unpredictable court systems, and the courts are often located, anyway, in urban centers far from the city slums and rural areas that are home to so many of the poor. When courts do not work effectively, vast numbers of poor people see no benefit to entering into legally

Figure 2.1
More regulatory obstacles in poor countries

Ratio of poor to rich countries



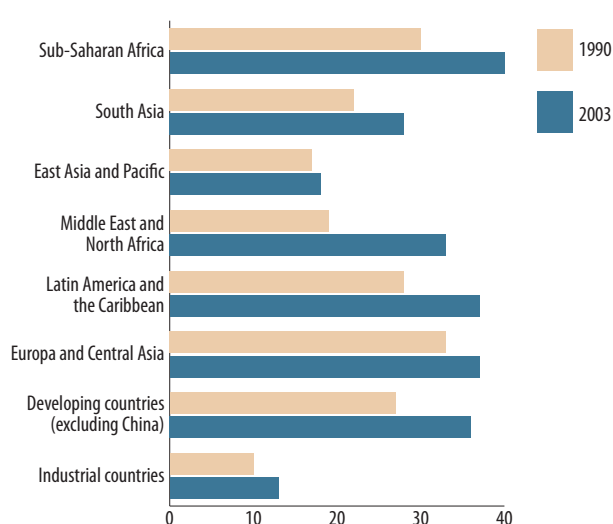
Source: Doing Business database

bound business and labor agreements, and they develop their own informal systems of justice distribution, which can be appropriated by organized criminal agents, such as drug dealers.

Given the plethora of barriers, it is not surprising that participation in the formal sector often boils down to a simple cost-benefit analysis. In the absence of fair access to formality, informality is the only reasonable option for many of the world's poor.

Figure 2.2
Worsening informality

Informal economy as a percentage of GDP



Source: World Bank 2004

2.3 Scope and magnitude of the problem

The informal sector is often massive in developing nations, and as shown in Figure 2.2, informality is worsening. In Egypt, for example, the ILD estimated the extralegal sector to be worth \$245 billion — six times the total amount held by the country's commercial banks in savings and time deposits, 30 times the market value of all companies registered on the Cairo Stock Exchange, 55 times the foreign investment in Egypt until 1996, and 116 times the value of the 63 private enterprises privatized between 1992 and 1996.

Tanzania, for example, engaged the ILD to discern “how the nation's extralegal economy actually operates and how the official legal system interacts with it.” After an extensive survey in 2004—05, ILD concluded that even though Tanzania has created much of the legal framework for citizens' participation in the legal economy, the majority of economic activity remains informal. For example, 98% of all businesses operate extra-legally, 89% of properties are held informally, and US\$29 billion in assets are held outside the formal economy. That represents a quantity ten times greater than the country's cumulative inflow of foreign direct investment since its independence in 1964.

More generally, informality in land holdings is typically indicative of the prevalence of business informality. In Africa, much of the land is held under customary tenure, which may or may not be recognized by national law. Most business in Africa is also conducted informally, though formality is more likely in urban areas or in rural areas that are the focus of investment from outsiders. Governments occasionally accept customary forms to conduct and organize business and form and enforce agreements, if not in law then in practice.

In South and East Asia, Latin America, Eastern Europe, and the post-Soviet countries, more than half of businesses are informal, although the proportions vary enormously by country. In some countries, particularly in Eastern Europe, significant amounts of land have been titled by the state, and titling is proceeding on a large scale — although some land also remains under customary tenure.

Informality is geographically least prevalent in North America, Western Europe, and Japan, where most land is titled and registered, and most businesses are conducted formally. Even in these developed regions, though, migration trends seem to be promoting growth in informal activities.

In terms of sectors, business formality is more common in urban and town contexts than in rural areas. Urban businesses are more likely to be registered, or at least to conduct part of

their business under formal rules. Informality is most pervasive in rural areas (where there is little incentive to be formal, since there is little interaction with formal businesses), in businesses that rely on the manual skills of the entrepreneurs, and in businesses that primarily sell merchandise (where bartering is common). Much of urban industrial, commercial, and residential land is titled, while rural and agricultural land is far less likely to be titled.

Informality, with concomitantly insecure tenure, is most evident in certain environments, including: illegally occupied areas, such as “squatter” settlements on the periphery of urban areas; public land, including environmentally protected areas and lands claimed as forest; land reform sectors where beneficiaries’ holdings have not been formalized; and places where there is extensive “tenancy” originating from former master-slave or other servile relationships.

One fact is clear: In its growing global scale, informality is not just affecting individuals but entire societies. As this paper goes on to discuss, informality is having a devastating impact socially, economically, and environmentally that is hindering the world’s poor from advancing to prosperity.

Size of the shadow economy (% of gross domestic product)

Regions ****			
Bolivia	65.6%*	Africa	42%
Peru	57.4%*	Asia	26%
Costa Rica	23.2%*	Latina America	41%
Argentina	21.8%*	European Transformation Countries	38%
Chile	18.2%*	OECD	17%
Thailand	71.0%*		
Philippines	50.0%*		
Sri Lanka	40.0%*		
Egypt	68.0%**		
Nigeria	76.0%**		
Morocco	39.0%**		
Ukraine	53.7%***		
Croatia	38.2%***		
USA	8.8%****		

* *Methodology:* Multiple-Indicator-Multiple-Cause (MIMIC) model
Date: average 1990-1993
Source: Loayza, Norman V. (1996): “The Economics of the Informal Sector: A Simple Model and Some Empirical Evidence from Latin America. Carnegie-Rochester Conference Series on Public Policy 45, pp. 129-162

** *Methodology:* Physical Input (Electricity) Method
Date: average 1989-1990
Source: Johnson, Simon; Kaufmann, Daniel; and Andrei Shleifer (1997): The Unofficial Economy in Transition. Brookings Papers on Economic Activity, Fall, Washington D.C.

*** *Methodology:* Physical Input (Electricity) Method
Date: 1999
Source: Lackó, Mária (1999): Hidden Economy an Unknown Quantity? Comparative Analyses of Hidden Economies in Transition Countries in 1989-95. Working paper 9905. Department of Economics, University of Linz, Austria.

**** *Date:* average 1999-2000
Source: Friedrich Schneider, “Size and Measurement of the Informal Economy in 110 Countries around the World”, The paper was presented at an Workshop of Australian National Tax Centre, ANU, Canberra, Australia, July 17, 2002.

Note: Regional data is average percentage based on the 23 African, 26 Asian, 18 Latin America and the Caribbean, 21 OECD, and 23 European Transformation countries surveyed.

3. Consequences of Informality: Real and Opportunity Cost

3.1 Social Impact

Insecurity and fear may not be quantifiable phenomena, but they are an intrinsic part of being poor. According to an excerpt from the World Bank's *Voices of the Poor*, poor people generally feel they have not been able to take advantage of new economic opportunities because of their lack of connections, information, skills, and credit. The poor, seeking physical and financial sustenance, drift or are pushed into informal employment, making their lives even more insecure and unpredictable.

The impact of informality on society is far-reaching. For example, informality breeds:

Fear and insecurity. In Africa, an estimated 70% of the urban population lives in slums. Squatter populations in big cities are highly vulnerable to dispossession. The consequences of these evictions are severe: besides destroyed property and lost assets, social networks are broken and access to essential services is absent.

Environmental and sociopolitical repercussions. Urban migration is expanding the number and size of informal settlements, creating serious environmental and sociopolitical implications that affect not only the residents of informal areas, but the growing urban population as a whole. Informal settlements increasingly encroach on environmentally sensitive areas, near protected water reservoirs, on public land, and into terrain that cannot be made habitable at reasonable cost.

Labor exploitation. Many of the world's poor are forced into the informal labor sector, including illegal spheres such as child labor, where they receive fewer benefits and lower wages than formal workers, as well as endure longer hours and more hazardous working conditions. They also have less bargaining power and representation than the formal work force achieves through unions and other labor organizations.

Lack of healthcare. More and more of the world's poor — especially those in the informal sector — lack adequate access to healthcare. The poor who already bear the brunt of the world's worst maladies, from malnutrition to HIV/AIDS, are made more vulnerable by their inability to access and pay for medical care.

Lack of quality education. In poorer countries, the education system is under-funded by governments. Informal contributions often keep schools afloat, but the low quality of education ensures that rates of illiteracy remain high, contributing to the inability of the poor to survive in the formal economy.

Social-political alienation. Informality cannot be viewed only in terms of individual needs and rights. Security of individual property rights, for example, must be combined with a broader, collective approach as regards the need to promote socio-spatial integration. Informality also breeds gender inequality, corruption, and political disenfranchisement — all of which compound the position of the under-classes. The undeniable link between informality and political alienation leaves the poor especially vulnerable to organized crime and other unscrupulous parties that rise up to fill the gaps.

Conflict. The poor are highly vulnerable to conflicts over scarce assets such as land. For example, land seizures and eviction of migrants have been characteristics of a number of conflicts in Africa. Refugees fleeing disputed lands also pose a land-management and social challenge for neighboring countries.

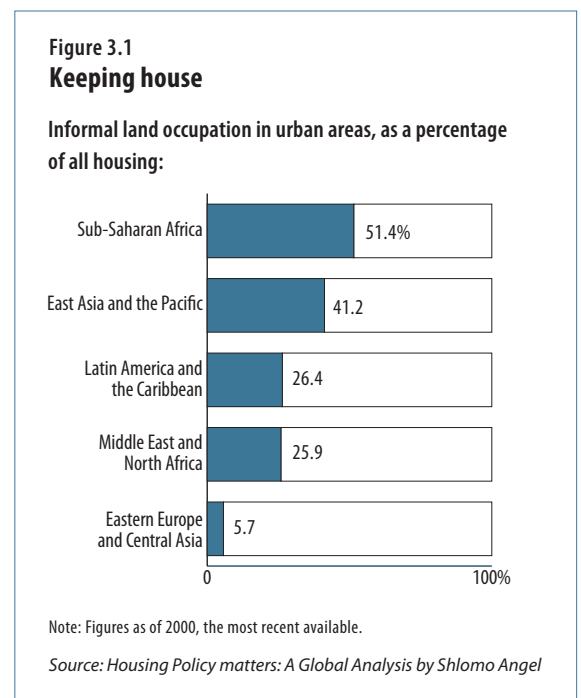
3.2 Land and Housing Informality — Lack of Property Titles and Official Recognition

In developing nations, informal land occupation is rife (see Figure 3.1 on urban occupation housing as an example). Even acknowledging the importance of rental housing and the need for governments to adopt a wide range of housing policies, land is the primary means by which many in the world earn a living, and invest, accumulate, and transfer wealth between generations. Without a proper title to their land, the poor may be deprived of the means, opportunity and incentive to leverage their land and resources in a productive way, and to avoid being politically marginalized.

According to de Soto, the world's poor have de facto access to considerable amounts of property, but inadequate ownership rights and tenure security mean that these resources cannot readily be turned into capital. Although the poor save — de Soto estimates the value of their aggregate savings at forty times all the foreign aid received throughout the world since 1945 — their resources too often are held in the defective form of untitled land.

Lack of property titles disadvantages owners, whether individuals or businesses, in numerous ways. For example, they:

- **Live in fear of eviction.** Millions of people living in informal settlements around the world face a constant threat of eviction — which may occur in a violent wave of forced removals that rob residents of their few possessions. The threat of eviction has the biggest impact on women and children.
- **Have less access to public infrastructure than titled land owners.** Only when land holders have official addresses and land deeds do municipal utilities find it financially feasible to incur the fixed costs of installing power and phone lines, and other services. With secure property rights, an electricity provider, for example, has an address where it can provide and monitor services as well as collect payments. Residents of informal settlements have no such services and are forced to spend time meeting basic needs, such as traveling to find water.
- **Must defend their property,** thereby diverting time and effort from productive activities, such as investment, and limiting the geographic scope and scale of their business activities. Land holders may also have to use precious resources to pay for bribes and protection.
- **Have little incentive to invest in their land** because there is no guarantee that the resultant increase in value will accrue to them, especially if eviction is a possibility. In a community of squatters, for example, dwellers often have little incentive to work to collectively better their immediate surroundings because they face risk of eviction. In urban Peru, untitled households invest in home construction at roughly one-third the rate of residents with secure property rights, according to the World Bank's Development Outreach program. Moreover, businesses also have less incentive to re-invest if they do not formally own their assets. A World Bank World Development Report says that firms in the former Soviet Union with confidence in their property rights reinvest between 14% and 40% more of their profits in their business than those that don't, and that farmers in Thailand with secure property rights had output that was 14%-25% higher as a result of greater investment in their land.

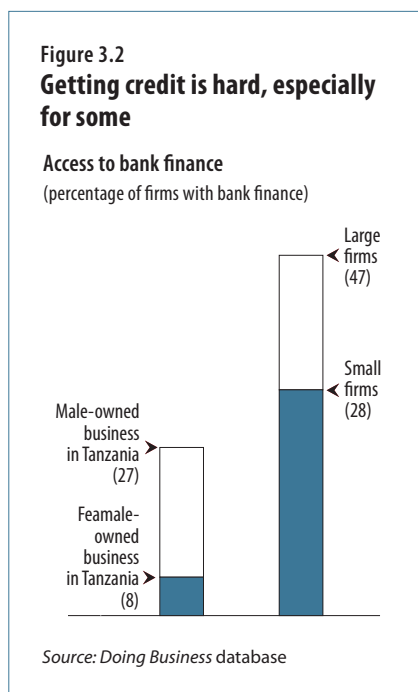


- **Do not have easy and fair access to credit.** Without formal property titles, small entrepreneurs often have difficulty obtaining loans to start businesses. According to the World Bank, many local banks prefer land and buildings as collateral since they are difficult to move or hide. In Zambia, 95% of commercial bank loans to businesses are secured by land, in Indonesia 80%, and in Uganda 75%. Without a title to use as collateral, individuals, households, and businesses lack access to credit that can be used as a vehicle for investment or as insurance against economic shocks (also see Section 4.1 on credit).

These consequences of informality are particularly visible among marginalized groups, such as women. Typically, a woman's freedom to rent, bequeath, or sell land is restricted in certain societies, limiting her productive capacity and often condemning her to landlessness, poverty, and alienation (also see Section 4.1).

3.3 Lack of proper access to finance

In many developing nations, the financial system is too immature and inflexible to offer viable services to potential customers from the ranks of poor individuals and small businesses. Many poor people would like to build a basic asset base, saving and borrowing to pay school fees, meet medical expenses, improve their dwellings, and invest in small businesses. But they generally have very limited access to the financial products and services that fuel growth in wealthy nations.



In fact, the poor typically have little option but to store their money privately, or to invest it in the form of livestock, jewelry, and cash — forms that can be illiquid, insecure, and fail to earn returns comparable to those offered by interest-bearing bank accounts. When banks are willing to service the poor, the product offering is seldom attractive or viable. Even when basic savings and credit products are available to the poor, there is rarely access to important risk mitigation instruments such as life, health, property, or catastrophe insurance.

Inadequate access to credit is one of the biggest obstacles for businesses in many developing countries. Smaller businesses are constrained the most, as are women, who are more likely to run small businesses (see Figure 3.2). Banks often want proof that applicants own property or other collateral or attest to reliable future earnings or revenues — provisions that the poor find all but impossible to meet.

Many people are forced to access finance informally, sometimes through savings and credit clubs or mutual insurance societies, but often through dubious routes such as pawnshops, or moneylenders. All of these informal options carry high transactions costs. For example, moneylenders may charge staggeringly high interest and abuse clients who fail to pay on time. *The Economist* reports, “In the Philippines, lenders who zip from town to town on motorcycles expect six pesos back for every five they lend. That translates into an annual interest rate of over 1,000% on a loan for a month”.

Systemic weakness, also common in the financial sectors of developing countries, affects the poor directly and indirectly. Bank failures, for example, occur relatively frequently in badly structured and poorly supervised financial sectors. The poor are affected directly when they lose deposits held in failed banks, and indirectly, when public-sector services are reduced because state resources are diverted to supporting the ailing bank sector.

Poor financial sector development has repercussions for entire economies. Whether the poor opt for informality by design or default, they are being robbed of the opportunity to channel their savings and wealth into investments. This dampens macroeconomic and social development and, ultimately, retards economic growth, keeping poor countries poor.

3.4 Lack of effective contract enforcement

Adam Smith, in *The Wealth of Nations*, described how problematic judicial systems can burden an economy, and it is not hard to imagine how his words might describe the poor in the informal sector: “[Commerce] can seldom flourish in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay.”

Smith’s words underscore how an insecure legal climate discourages economic growth. Today, unpredictable rules and inadequate access to effective dispute-resolution mechanisms still prevent many individuals and entrepreneurs from participating in the formal justice system. In fact, ineffective and corrupt systems encourage the development of informal systems, from peer pressure to more unscrupulous options such as organized crime, which may lead to violence and abuse and are quick to target the disenfranchised poor.

The cost of inefficient regulation is another legal burden that hits the poor hardest. The Doing Business survey — which follows the evolution of a payment dispute, and tracks the time, cost, and number of procedures in selected business processes throughout 155 countries — show, for example, that in some developing East Asian countries, the judicial or administrative system is painfully slow and is so inefficient at collecting overdue debt that it costs more than the face value of the debt to recover it. Respondents to a World Bank poll in Peru said they would not switch from their trusted supplier to a lower cost one for fear that the new supplier would fail to uphold his end of the bargain. A similar survey in Ecuador found that businesses were hesitant to invest because of uncertainty about contract enforcement.

4. Promoting migration to the formal sector

4.1 Approaches and experiences

As noted in Section 1.3, the Commission's work is based on the assumption that reforming legal and ownership systems to increase the inclusion of the poor in the formal sector can contribute to alleviating poverty and promote sustainable growth and development. Separately, governments have been driven to pursue formalization initiatives for a variety of reasons, including attempts to increase government revenues from land or businesses, access the substantial donor funding available for these purposes, and create an environment attractive to both private domestic and foreign investment.

Several types of formalization-related initiatives are already proceeding in nations around the world. We have focused here on just a few of the most far-reaching areas of reform, but the various experiences — and varying degrees of success — offer invaluable lessons and raise important considerations for reformers.

Expansion of the rule of law to broader segments of the population. Most prosperous economies have judiciaries that enforce contracts, protect property rights, and punish corruption: all factors that catalyze economic growth and foreign investment. When judicial systems are corrupt, unprofessional, and unpredictable — as many are in developing countries — using the system comes at a high risk and cost.

Reformers have taken different tacks in seeking to strengthen justice systems. In some cases, reform requires a total overhaul of existing systems that are, for example, riddled with corruption. In other cases, impact can be achieved even with piecemeal reforms such as initiatives to expedite case handling or build legal capabilities. For example, improving the training of lawyers and judges can inspire confidence among plaintiffs that justice will truly be served.

Information-sharing can be another useful tool. Formal sectors that provide records about defaulting parties help reduce business operational risks and make formal transactions far safer than informal ones. Some disputes can be avoided altogether if authorities have accurate records of land and businesses ownership. Moreover, lawyers and judges can strengthen their expertise when they have access to more complete records on precedents in common law systems.

Guatemala undertook a judicial reform program in 1998, receiving \$33 million from the World Bank to support its efforts. As well as strengthening the management and operations of the central judiciary, the reforms made the courts more accessible. The Judicial Branch set a target of equipping every municipality with a justice of the peace court, and every departmental capital with criminal, civil, family, and labor courts. Since 1997, court coverage has increased by 54%. Extra-legal mediation has also become a much more viable, accessible, and cost-efficient approach to resolving disputes. Alternative dispute resolution (ADR) mediation centers handled 14,992 cases between 2002 and 2004, most related to land and property disputes, child maintenance, domestic violence, contract enforcements, and minor criminal offences.

There have also been significant advances in alternative dispute resolution in countries of the former Soviet Union. Third Party Arbitration Courts (TPAC) have been developed to help implement land and agrarian reform processes in Russia, Ukraine, Moldova, Krygyzstan, Georgia, and more recently, in Tajikistan. The reform has proved to be fundamental to

ensuring that land reform is fair, transparent, and beneficial to the poor. In the TPAC system, the disputing parties together select a third party to mediate, and, if necessary, resolve their case. The mechanism is cost effective and speedy: disputes are usually settled within two weeks and never take longer than two months.

Judicial reforms, while aimed at greater public participation as a whole, are also seeking to acknowledge the special needs of certain sub-groups, especially women and ethnic groups — parties that tend to have the weakest legal protection. For example, USAID is partnering with The Asia Foundation to train women as family-dispute mediators. The mediators can handle almost all family issues in a matter of weeks, compared to the interminable process that similar cases can endure in the courts. A pilot study in the Philippines showed that more than 80% of cases referred to mediation by regional trial courts were settled quickly. Separately, USAID sponsors the Legal Accountability and Dispute Resolution (LADR) program in Asia. One LADR project is helping popularize the Code of Muslim Personal Laws in the Philippines by developing primers in local dialects. The Code covers family law and institutions, such as divorce, paternity, succession, and inheritance under the Shari’ah courts that are part of the Philippine system.

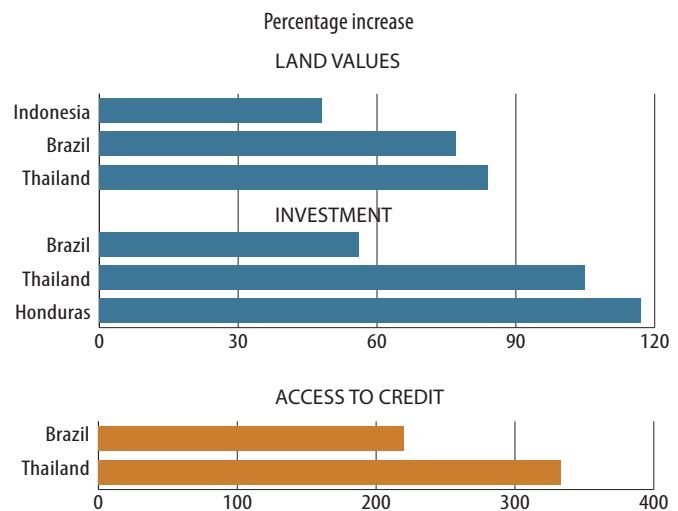
Formalization of land and other property. Since land tends to comprise a large share of the asset portfolio of the poor in developing countries, many land-reform efforts are focusing on the creation of predictable legal protection for property. In West Africa, for example, it is estimated that less than 2% of land has any formal paper documentation, with most rights claimed through unwritten systems of tenure. As land values rise rapidly, such unwritten claims to land are increasingly at risk.

Moreover, population growth and market development are creating mounting competition for land, by intensifying the need for formalization efforts.

Many reformers argue that once informal land holders receive a property title — formal documentation that serves as evidence of ownership — they can leverage their legitimized asset to increase their net wealth, be more productive, be less reliant on wage labor, and more able to withstand economic shocks. In short, property titles — by defining and protecting land assets — are believed to bolster land values, and increase investment and access to credit for owners, as shown in Figure 4.1.

However, this assumes that titles confer certain rights to occupy, use, and develop land — and reap the benefits of any improvements made thereon. Another key piece of the equation is tenure: the way in which land is held or owned, or the set of relationships among people concerning the use of land. Individuals, families, and other collectives, such as village and clans, and businesses, can all register claims over property, but the rights and terms of tenure can vary considerably in different cultural and economic contexts. For example, very large areas of land in Africa are held under customary tenure where governments provide little or no legal protection to such unwritten rights. In such cases, rights may be legitimate in terms

Figure 4.1
Defining and protecting property rights — large benefits



Note: Based on analysis of household survey data comparing titled and untitled property

Source: Feder (2002)

of locally recognized claims to land, but have no formal legal qualities.

Individual titling is not the only way to confer property rights. In some cases, collective titling — to a village, for example — can be effective. Individual/collective leases can also unleash many of the productive economic benefits delivered by property titles. Certainly, leaseholds can offer the requisite assurance to property investors (though few financial institutions will accept leases as collateral). Other options include individual and collective freeholds, rental housing programs, permits and authorizations, and cooperative systems.

Titling can have explicit drawbacks, especially if it is not conducted within the context of specific measures aimed at preventing abuse. These include: windfall profits to squatter “owners”, who sell up as soon as informal tenure is granted; the eviction of tenants; the growth of new unauthorized settlements by groups who hope that formal titles will also be awarded to new areas; and the potential distortion in property prices caused by the buying up of newly formalized settlements by higher-income groups hoping to capture much of the gain.

In 2002, for example, the World Bank helped the government of Cambodia launch an initiative aimed at distributing more than a million titles throughout the country. However, in the run-up to the launch, more than 23,000 squatters were evicted from prime inner-city land around the capital of Phnom Penh. This type of “land grab” pushes the poor even farther from sources of income and services. Some urban planners recommend, therefore, that titling programs incorporate a ban on evictions and relocations and a temporary granting of land rights to neighborhood groups, followed by the long-term phasing-in of more formal, socially acceptable solutions. Singapore, for example, has adopted policies that have brought affordable housing within the reach of the majority of the citizens of the city-state, despite rapid urban growth.

Issues of title can be especially complex when they relate to the rights of women and ethnic sub-groups. In the case of women, for example, social, legal, and economic barriers may prevent them from owning property. Even when women have access to land ownership, they need access to other economic stimuli, such as credit organizations, extension services, labor, and markets to create opportunity.

Ethnicity can also make land formalization politically explosive. For example, land sales became legal in Kenya for the first time when customary land tenure was titled and registered as individual private ownership in the 1960s and 1970s. A few commercially advanced ethnic groups were able to purchase vast amounts of land from other groups, eventually creating deep resentment and a violent backlash.

Improvements in land stock-taking and registration processes. There are many forms of property-title registration, from short-term certificates of occupancy to more formal registers and titling procedures. In many countries, though, registration systems are prohibitive and exclusionary, anachronistic, burdensome, and costly. Easy property registration, by contrast, correlates to reduced informality, lower levels of corruption, and higher levels of credit and investment, according to *Doing Business* data (Figure 4.2 on p. 17).

According to the report, “In the average African country a simple formal property transfer in the largest business city costs 14% of the value of the property and takes more than 100 days. Worse, the property registries are so poorly organized that they provide little security of ownership. For both reasons, formalized titles quickly go informal again. Even if titles remain formal, they don’t amount to much if governments control property prices and restrict the ability to trade.”

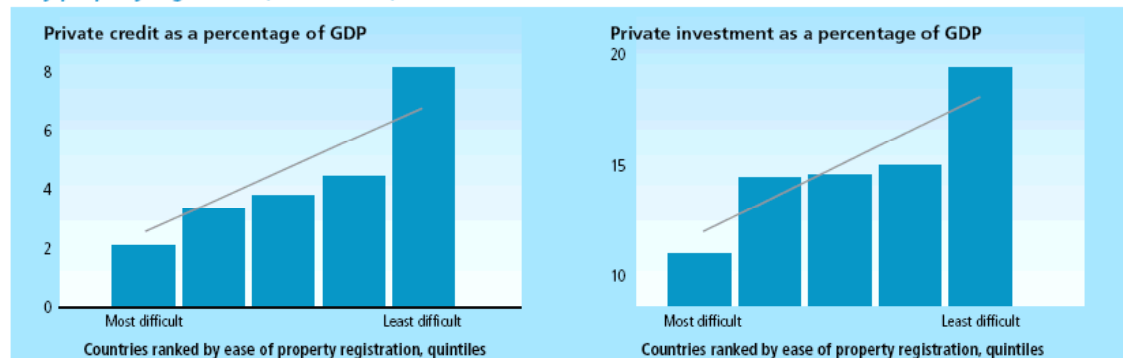
Figure 4.2

Easy property registration—more secure property rights, less informality, less corruption



Note: Analysis controls for income per capita. Relationships are significant at the 5% level.
Source: *Doing Business* database, Heritage Foundation (2004), Kaufmann and others (2003).

Easy property registration, more credit, more investment



Note: Relationships with private credit remain significant at the 1% level when controlling for income, contract enforcement, and GDP growth, at the 10% level for investment when controlling for income.
Source: *Doing Business* database, World Bank (2004).

In fact, some evidence suggests that formal registration processes are neither necessary nor sufficient to generate tenure security. Pilot cases from Ethiopia, Mozambique, and Benin demonstrate the value of simple, low-cost, locally tailored methods that are rooted in local values and build on existing practice. In many places, land rights registration may be much less important than working to strengthen local institutions with responsibility for managing land disputes. Certainly, the costs of land registration and administration need to match the value of land. New technologies such as Global Positioning Systems, computerization of records, and Geographic Information Systems can help. But technology is no substitute for a locally legitimate process to adjudicate disputed claims. The local knowledge of neighbors is essential to clarify rights and boundaries, for example. And it is important to reconcile registration systems with cadastral systems used by authorities, to modernize both systems and to make information available to the public.

Reductions in cumbersome and inefficient business regulations. A growing number of countries now realize that to encourage the kind of entrepreneurial activity that creates jobs and contributes to macroeconomic growth, they must reduce the regulatory obstacles to formal participation. In a nutshell, there is no reason for the cost of doing business in low-income countries to be many multiples that of similar procedures in wealthy ones.

Removing burdensome regulations allows businesses to concentrate on creating growth and profits and produces savings for governments. The World Bank's *Doing Business* studies have shone a bright light on the value of reforms. The *Doing Business* indicators benchmark the costs in 155 countries associated with starting and closing a business, dealing with licenses, hiring and firing workers, registering property, obtaining credit, paying taxes, enforcing contracts, and trading across borders. *Doing Business 2005* reports "a hypothetical improvement on all aspects of its *Business* indicators to reach the level of the top quartile of countries is associated with an estimated 1.4 to 2.2 percentage points in annual economic growth".

The ILD is among those championing the simplification of legal and regulatory frameworks for businesses. For example, the ILD created a reform plan for Peru's President Alberto Fujimori that included provisions to streamline the arduous business-registration process. The reforms created a "one-stop" shop for registrations that enabled entrepreneurs to obtain a new-business license in just one day, compared with the nearly 300 days required previously. The cost was slashed seven-fold, from US\$ 1,200 to US\$ 174. Between 1991 and 1997 alone, 671,300 businesses were legalized, creating 557,770 new jobs, according to the ILD.

Vietnam has had a similar experience since introducing its new Enterprise Law in 2000, which made it much cheaper and faster to form a new business. Under the new law, it took only seven days to start a business legally, down from 98. According to estimates, 40% of newly registered firms already existed in an informal form.

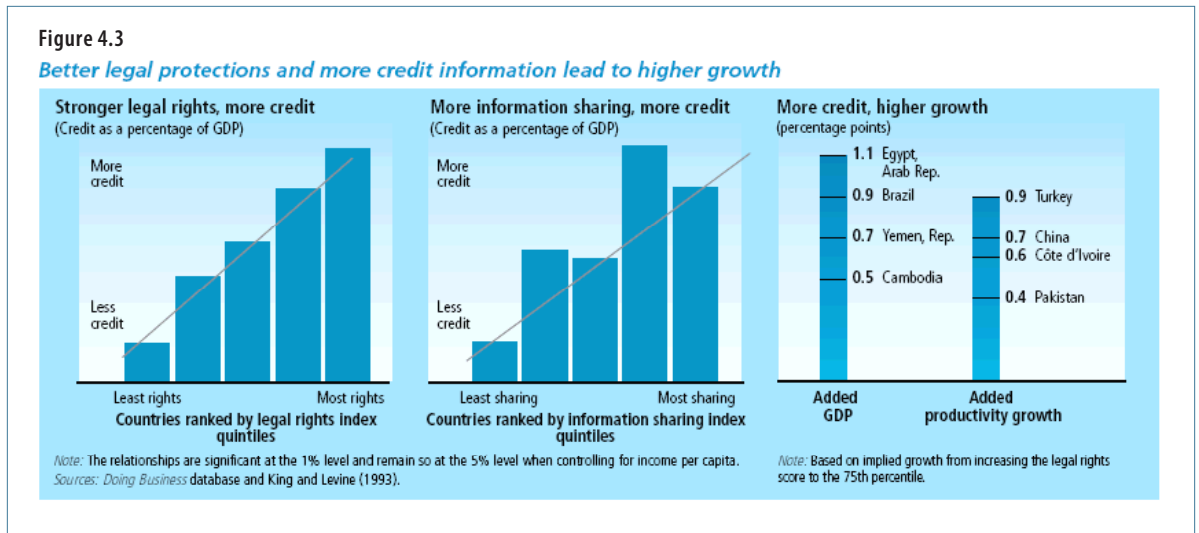
China, meanwhile, has continued to revise its company laws to encourage entrepreneurialism. Most recently, it slashed the amount of minimum capital required to start a new domestic business. Effective on January 1, 2006, new limited liability companies need only RMB30,000 (about US\$ 3,750) in capital. Previously, the capital requirements varied by sector, with manufacturing requiring the most (RMB500,000). The new law also allows as much as 70% of total registered capital to be held in non-cash items, such as intellectual property and technology.

Improved access to credit. Access to credit is one of the most important vehicles of growth in developing countries. Improving access to credit often requires the structural and regulatory reform of the financial sector. For example, regulators can open the financial sector to increased competition, especially foreign competition, encourage local banks to innovate and broaden their offerings of reasonably priced products and services, and expand their customer base. For example, in 2004, China removed the ceiling on lending rates, enabling banks to price loans higher to reflect the risk of lending to new customers, especially among SMEs.

Banks themselves can pursue process and information-sharing efficiencies, which help to reduce operating costs and create savings that can be passed on to customers in the form of lower transaction fees or reductions in minimum balances. Transparency of credit information, for example, can help to improve credit services, especially when supported by high-quality legal and titling systems to facilitate and legitimize the use of collateral.

Many developing countries have and share little credit information. Some, including Albania, Ethiopia, and the Kyrgyz Republic have no registries or other forms of information sharing at all. But evidence suggests that broader sharing of credit information, along with stronger enforcement of collateral rights, results in more credit and higher rates of growth (see Figure 4.3 on p. 19).

There are various ways to encourage the proliferation of financial services that cater specifically to the needs of the poor and SMEs. Regulators can, for example, be aggressive in



stamping out predatory and other discriminatory lending practices and encourage alternatives that are viable for the financial institutions and customers. For instance, regulators can be accommodating to non-bank institutions that want to offer only certain financial services such as money transfers. This might mean, for example, developing specific frameworks and operating requirements for micro-finance institutions and small-scale activities of commercial banks.

Microfinance has already proven to be an alternative vehicle for bringing capital to the poor. Nevertheless, microfinance has substantive limitations, not least the fact that it can actually perpetuate participation in the informal economy. Although the sector has clearly played an important positive role in assisting poor communities to gain access to loans microfinance typically remains structurally disconnected from the dynamics of the market economy. The prospects for microfinance to impact informality are best in those instances where the institutions are relatively large and well managed and operate as an integral part of the mainstream financial sector with the standards of transparency, efficiency, flexibility, breadth of services and governance.

4.2 Overview of reform capabilities among international organizations

Various donor and other international organizations have been active in formalization efforts.

The **World Bank (WB)** has played a major role in funding and encouraging formalization efforts in both the land and business sectors. It recognizes the need to provide security of tenure to informal settlements wherever possible, and has done important work in this area in connection with its involuntary resettlement policy. It is the largest single participant in land administration (primarily titling and registration) programs, and has more than 25 major land administration projects underway around the world.

The **Institute for Liberty and Democracy (ILD)**, created by Hernando de Soto, is a Lima-based think tank working on both land and business formalization issues. It has been an important source of new ideas related to informality in recent years, given wide circulation through de Soto's book *The Other Path*, which drew the attention of development policy makers to the extent of informality and the possibility that formalization could contribute to poverty alleviation. The ILD has conducted extensive diagnostic work in Haiti, Mexico, Egypt, Honduras, and Tanzania on informality and formalization needs and strategies, although its experience with implementation is essentially confined to Peru.

The **FAO's Land Tenure Service (FAO/LTS)** provides a critical mass of interdisciplinary expertise on land tenure issues of global reach. The LTS is particularly focused on advising donors and governments and facilitating knowledge-sharing.

The **European Union (EU)** has been a major supporter of land titling and registration efforts in transitional areas of Europe and Asia, and is perhaps the most influential donor on land policy issues in Eastern Europe and the countries of the former Soviet Union, through both its development assistance and its influential 2003 Land Administration Guidelines.

United Nations HABITAT, based in Nairobi, has emerged in the last few years as an important source of expertise on urban land tenure and land tenure in relation to housing issues. It is an active participant in discussions on formalization.

USAID has been a major supporter of strengthened property rights and business formalization. It has supported significant legal and judicial reform, land titling and registration, particularly in the former Soviet Union and Eastern Europe. It has a relatively nuanced viewpoint on land titling and its limitations outside countries in transition. USAID has provided funding for the ILDC's diagnostic studies, and has supported numerous commercial law reform projects.

The **UK Department for International Development (DFID)** has supported land reform and rural development program that contribute to poverty reduction since the early 1990s. In addition to supporting implementation of agrarian reforms in Africa, Asia, Latin America and Europe and Central Asia, DFID has supported research, analysis and policy advice on various aspects of legal empowerment of the poor, including improved governance and access to safety; security and justice; microfinance support; income generation, job creation and promotion of entrepreneurship, particularly for women and vulnerable groups; promoting public-private partnership; and promoting fair trade

In Europe and Central Asia, DFID's work in the early 1990s focused on land reform, market liberalization and extension services. From 1997, DFID has supported a more comprehensive, sustainable livelihoods approach to legal empowerment in partnership with governments, civil society organizations and international agencies. DFID has piloted new approaches at national and sub-national levels to provide evidenced based support national policy reforms, including implementation of new land codes and establishment of third party arbitration mechanisms to mediate and settle land and other disputes.

The **International Land Coalition (ILC)** is an association of non-governmental organizations, governments, and international organizations based at IFAD in Rome. It provides an important source of information on the thinking of international and national NGOs on formalization issues. It has special potential as a discussion forum between advocates and critics of formalization. The ILC's experience to date suggests a number of factors that affect the success of efforts to empower the poor through formalization and related reforms dealing with land law and legal empowerment. Success, it says, should be measured not in terms of number of laws enacted, parcels surveyed, or businesses registered, but in terms of what formalization delivers: how many individuals and businesses find their situations significantly changed, and in what ways, both positive and negative.

5. Key considerations

Informality is a complex issue and addressing it involves complex policy responses and reform initiatives. Some observers stress that facilitating the process of migration from the informal to the formal sector is essential to alleviating poverty and ensuring long term, sustainable development. Others stress that informality, at its core, reflects a set of circumstances that ought to be respected — that it is “a necessary evil,” which should be respected for the purpose it serves (however dysfunctional) as a lifeline for the poor.

With due regard to the many prevailing perspectives, the Commission believes that informality carries with it high social and economic costs and that in the longer term, it undermines the full economic and political empowerment of the poor.

Some realities are clear:

- **Informality is growing in scale and scope.** Globally, the informal sector has been expanding in the last decade. The magnitude and rate of increase are considerably more dramatic in developing countries where informal sector growth dwarfs the formal sector, further distorting the land and property markets.
- **Informality undermines economic growth and the prospects for prosperity.** Informal assets cannot be leveraged as collateral, lack of secure tenure discourages households from investing in their homes, informal settlements lack basic infrastructure and services, informal businesses are often sub-scale and under-invested, and informal workers often lack access to the requisite education and training. Informal activities, therefore, fail to add to productivity and growth to the same degree as formal activities.
- **Informality has broad social and environmental consequences.** Informality is an undeniable part of the daily lives of the poor. It affects the conditions in which they live and work and, most importantly, constrains their capacity to progress and eventually prosper. Most vulnerable in society are the world’s poor women and children. Also at risk is the ecosystem into which informal settlements are inexorably spreading.
- **Informality is affected by the policies of national and local governments.** Reducing informality requires policy initiatives and structural reforms that create real incentives for governments and ultimately improve the capacity of national and local governments to generate sustainable growth. The success of reforms will be affected by the commitment of national and local governments to reducing structural injustice, and to the priorities they assign to financial sector development and competition, dispute resolution and legal enforcement, social equity, and environmental protection.

So, what are the challenges for reformers?

- **Building consensus.** Reformers must establish a broad-based consensus for initiatives that address the informal sector: This must be built on empirical evidence; common understanding of real impacts and risks; deep knowledge of local contexts and environments; consultations with key stakeholders, and a

shared platform among the key institutions promoting migration to the formal sector. It will be vital to engage opponents early on.

- **Implementing effectively.** Reform itself must proceed comprehensively to achieve good policy, law, regulations, processes, and enforcement mechanisms in parallel. The proper sequencing of reforms will maximize the impact. It is tempting, too, to define formality in terms of the pieces of paper that confer legitimacy — such as licenses, registrations, or titles. But while it is clearly important to reform the processes that underpin and effect legitimacy, those processes cannot replace or supplant structural change.
- **Looking forward.** There is no denying that many issues of informality are highly contentious and political, often reflecting inequities borne of long and sometimes bloody histories. But arguably the biggest threats still lie ahead. Global and local forces, from trade liberalization to rapid urbanization, climate change, and the devastating impact of HIV-AIDS, will exert huge pressure on resource planning and management. If informality is allowed to persist in the face of these forces, more people, will join the ranks of the poor.
- **Seeing the big picture.** It is easy, too, to become bogged down in the discussion of individual rights at the expense of macro-effects. Conserving common property resources is vital for a wide range of natural resources users and for ensuring continued ecosystem services. Maintaining access to common property resources is especially important for the livelihoods of poor people.
- **Avoiding perverse effects.** As we acknowledged at the outset, observers are right to note that challenging informality, in up-ending the status quo, can inadvertently cause collateral damage to the very people who should be helped most by a move to formality. It is vital to understand, therefore, the broad repercussions of reforms, especially the impact on women and other large sub-groups of the informal and poor.

In short, the Commission does not believe the validity of informality is in question, but it acknowledges that change is difficult for reformers and those whose lives will change. The key is to create the right conditions for reducing informality. That will mean removing obstacles to entering the formal economy and offering incentives to make it desirable and feasible for participants in the informal economy to migrate to formality.

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