

KEYWORDS

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A boom in a heterogeneous economy.

Peru 2002-2006

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One part of Peru's population failed to benefit from the economic boom in 2002-2006, among other reasons because of the deep-rooted productive heterogeneity present in the Peruvian economy. In 2006, microenterprises and self-employed persons with family workers accounted for 53.4 % of total employment, but productivity and average labour incomes were very low in that segment. As the corresponding incomes grew very slowly between 2002 and 2006, the gain in well-being was very slight despite the boom that was being experienced elsewhere in the economy. Looking to the future, it will be essential to develop policies targeted on microenterprises with competitive potential, to achieve rapid productivity growth that raises the well-being of their employees. It will also be necessary to recognize that the impacts of economic policy differ between microenterprises and larger firms, so that specifically targeted measures can be designed to improve microenterprise competitiveness.

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I

Introduction

This paper discusses why the economic boom in Peru in 2002-2007 was not perceived as such by a large proportion of the population. One reason is the Peruvian economy's profound productive heterogeneity, which is associated with a very highly segmented labour market. This explains why the rapid growth and modernization of certain segments of the economy did not spread as quickly towards other segments.

Section II describes the backdrop to the boom that started in 2002. Section III considers the uneven

growth in employment and labour incomes in the various segments of the labour market, highlighting the importance of microenterprises for understanding how the country's labour market operated. Section IV stresses the need to design policies targeting microenterprises that have greater competitive potential; it then analyses the range of current policies, and makes suggestions for the future. Section V sets out the main conclusions.

II

Setting

Between 2002 and 2006, Peru experienced the most vigorous economic upswing of its recent history, following the 1950-1955 boom fuelled by the Korean War. A rapid expansion in the external demand for minerals and other extractive products was accompanied by the impact Andean Trade Promotion and Drug Eradication Act (ATPDEA)¹ in the United States, which, by lowering tariff barriers, stimulated the diversification of non-traditional exports to that country. Additional factors were the promotion of non-traditional exports to many other countries of the world and a macroeconomic policy that gave priority to stability.

Traditional and non-traditional export earnings grew rapidly during 2002-2006 (30% per year in current dollars) and 12% at constant prices. The ratio of exports to gross domestic product (exports/GDP) at current prices rose from 14% in 2002 to 28% in 2006. All of this also generated a surge in tax revenues, which made it possible to expand public expenditure and reduce the fiscal deficit to a very small amount.

As a result, GDP growth accelerated from 3.9% in 2003 to 6.4% in 2005, 8.0% in 2006 and an estimated 8.9% for 2007. During the same period, total productivity

recovered to grow at 2.5 - 3% per year for the first time since a brief interregnum in 1993-1996. Gross fixed investment tracked GDP growth, albeit with a lag, thus helping to create new jobs. In particular, the rate of growth of employment in urban establishments with 10 or more employees, accelerated from 3.0 percent in 2003 to 5.7% in 2005, with figures above 8 percent per year estimated for 2006 and 2007.

One of the surprising features of the current Peruvian boom is that the way it is perceived by one part of the population seems to differ from the view held by economists. In 2003-2006, a large proportion of the population did not consider they had benefited from the economic success. In the 2006 presidential elections 47% of the electorate voted to abandon the successful economic model and return to old populist practices, including development of the domestic market and nationalizations.

Several factors converge to explain this mismatch between economic success and its perception by a very large fraction of the population. These include highly unequal access to opportunities at the outset; the lag with which economic growth affects employment and incomes; the concentration of exports in a relatively small number of firms; and the technological backwardness of the vast peasant economy in the Andean *sierra* region. This article aims to explore just one of those factors, namely

¹ Andean Trade Promotion and Drug Eradication Act, of the United States.

the high degree of productive heterogeneity existing at the outset and its effects on the growth of employment, income and welfare among the population.

Peru has one of Latin America's most productively heterogeneous economies. This is a feature of nearly all of its markets and productive sectors. In a given activity, alongside a large modern enterprise endowed with state-of-the-art technology, cutting-edge business management, highly qualified and experienced staff and a dynamic export market, there are also numerous microenterprises or small businesses that are extremely backward, displaying rudimentary technology, weak management capacity, inexperienced and unskilled workers, and a precarious positioning in local markets.

Heterogeneity causes segmentation in product and factor markets. These do not adjust like their homogeneous counterparts, but the various segments

adjust in different ways and at different speeds. If the Central Reserve Bank lowers the benchmark interest rate by half a point, credit becomes cheaper for organized and formal private enterprises, and this probably helps to increase their demand for credit. But the interest-rate cut does not produce the same effect among microenterprises, for which credit will remain rationed and very expensive.

The above is particularly true for a segmented labour market like that prevailing in Peru, in which the dynamism of modern sectors and the corresponding labour-market segments is not automatically and proportionally transmitted to those that are less structured. Segmentation does not mean that there are sealed compartments within the labour market, but obstacles, shortcomings and barriers that intermedicate the effect that changes occurring in certain segments has on others.

III

Growth of employment and labour income by establishment size

1. Trends in 2002-2006

The first column of table 1 summarizes employment growth by labour-market segment in 2002-2006. As the table shows, employment grew very little in medium-sized enterprises (50 to 199 employees) and large firms (200 employees or more); in contrast, it grew at a rate of 6.4% per year in small businesses (10 to 49 employees) and by 5.0% per year in microenterprises (2 to 9 employees), according to data from the National Household Survey (fourth quarters, 2002-2006). The National Survey of Wages and Salaries, covering establishments with 10 or more employees, produces a more optimistic result: aggregate employment among small, medium-sized and large firms grew at 5.3% per year during the same period, accelerating to 5.7% in 2005 and 8.9% in 2006. The (national) open unemployment rate fell from 6.0% in 2002 to 4.5% in 2006.

With such strong job growth in formal segments of the labour market, how could the population at large not have perceived an intensive improvement in welfare? The answer can be found in the second column of table 1.

In 2006, despite the very rapid expansion of formal employment, 53.4% of all jobs were in microenterprises, and 16.2% corresponded to unskilled self-employment, thus in total encompassing almost 70% of jobs in the country. A large fraction of these two categories usually forms part of what many analysts refer to as "informal employment". The International Labour Organization (ILO) measures informal urban employment as the aggregate of persons working in microenterprises with up to five employees, together with unskilled self-employed workers, unpaid family members, and persons in domestic service.

As a counterpart, after five years of rapid growth, employment in small, medium-sized and large enterprises accounted for just 17.2% of the country's total employment in 2006. Consequently, despite significant growth of quality jobs in these categories, their contribution to total employment growth, and thus to aggregate welfare, was relatively small.

Moreover, in 2002-2006, the proportion of unskilled self-employed workers shrank —because of the faster growth of employment in establishments of all sizes—

TABLE 1

Peru: employment by segments, 2002-2006^a
(Percentages)

	Annual average growth	Percentage composition
1. Public sector	3.4	7.5
2. Medium-sized and large enterprises (50 employees or more)	0.4	9.4
3. Small enterprises (10-49)	6.4	7.8
4. Microenterprises (2-9)	5.3	53.4
- 6 to 9 employees	10.4	15.7
- 2 to 5 employees	4.2	37.7
5. Skilled self-employed ^b	-0.4	0.9
6. Unskilled self-employed	1.1	17.1
Urban	1.9	12.8
Rural	-0.8	4.3
7. Domestic service	5.4	3.8
8. Total employment	3.8	100
9. Unemployed	-2.1	4.5
10. Employment rate	-	95.5
11. Total economically active population (EAP)	3.4	100

Source: National Institute of Statistics and Informatics, National Household Survey (fourth quarters, 2002 and 2006), Labour Statistics and Studies Programme (PEEL) of the Ministry of Labour and Employment Promotion.

^a Figures for 2006 are preliminary. Unpaid family workers are recorded in the category of enterprise in which they were working. The skilled and unskilled self-employed categories exclude unpaid family workers. Self-employed persons with unpaid family workers are included in the microenterprise or small firm segment, depending on the number of family workers.

^b The skilled self-employed include professionals, technicians and the like.

from 19.5% to 17.1% of the total; but in absolute terms it was far from offsetting the predominant trend.

This dichotomy between jobs in microenterprises and unskilled self-employment on the one hand, and employment in small, medium-sized and large enterprises on the other, is important in explaining the differences in average labour income between those segments. Table 2 presents data on monthly labour income in 2006, by segments, using two sources: the National Household Survey, fourth quarter, and the National Survey of Wages and Salaries in establishments employing 10 or more workers. As this table shows, average monthly labour income in microenterprises was roughly 561 soles, equivalent in 2006 to about US\$ 174. In that year average labour income among the unskilled self-employed was

even less than that of workers in microenterprises.² It should be recalled that the skilled self-employed category encompasses not only professionals and technicians, but also other similar workers; so the very low-skilled self-employed, who in practice are usually informal—e.g. a plumber—also include those who have no skills. This helps to explain income trends between one category and the other. In the case of an unskilled self-employed worker in the rural sector, average monthly labour income recorded in 2006 was 240 soles, equivalent to US\$ 75. In contrast, as the same table shows, average monthly labour income in small, medium-sized and large enterprises doubled, tripled or even quadrupled that recorded in microenterprises, depending on the size of the establishment and the statistical source used.

The above is strengthened by another development that occurred in 2002-2006. Average monthly labour income grew slightly in medium-sized and large firms; it grew substantially in small firms, given the increase in the proportion of employees and because their wages rose at a rate of 7.8% per year in real terms; and it grew much more slowly in microenterprises: 2.4% per year in real terms. Given the very low level at the outset, this meant an increase of 77 soles in current prices over four years, equivalent to US\$ 23 (i.e. US\$ 6 per year). Monthly labour income decreased in the unskilled self-employed segment, in both real and nominal terms.

Thus, part of the explanation is that most employment in the country is in very low-productivity jobs, which have not seen a significant improvement in their very low incomes during the boom period. Employment in the higher income and productivity segment may grow rapidly; but, given its small initial weight, thus far it has had little effect on total well-being, which does not mean that it could not rise greatly over a longer term.

The dichotomy between microenterprises and small, medium-sized and large firms is also relevant because of a second feature of the Peruvian economy: a large percentage of wage-earners are either unregistered or have no legal employment contract; they receive less than the minimum wage and have no access to non-wage labour benefits. In 2006, over 55% of private-sector wage-earners did not have a legal employment contract (MTPE/PEEL, 2007), and over 75% of those in microenterprises were also in that situation. As the proportion of wage-earners without a contract is much

² Apart from possible sampling errors, a decisive factor explaining this trend is that growth in the demand for labour has been concentrated among skilled workers, while the demand for unskilled workers has declined.

TABLE 2

Peru: monthly labour income, by segments, 2006^{a b}
(Soles at 2006 prices)

	National Household Survey	National Survey of Wages and Salaries in establishments with 10 or more employees
1. Large firms (200 or more)	1 603.5	2 501.1
2. Medium firms (50 to 199)	1 270.7	1 940.2
3. Small firms (10 to 49)	792.4	2 323.7 ^c
4. Microenterprises (2 to 9)	561.4	
2 to 4 employees	528.2	
5 to 9 employees	742.7	
5. Unskilled self-employed ^d	38.6	
Urban	437.8	
Rural	239.3	
6. Skilled self-employed	973.5	
7. Domestic service	523.3	
8. Public sector	1 257.6	

Source: National Institute of Statistics and Informatics, National Household Survey, fourth quarter of 2006; and Survey of Wages and Salaries in establishments with 10 or more employees (June 2006). Labour Statistics and Studies Programme of the Ministry of Labour and Employment Promotion (PEEL/MTPE).

^a Preliminary figures.

^b Average monthly income excludes unpaid workers.

^c Average labour income in this segment is high because of the larger number of employees in establishments with up to 49 workers, especially in commerce and services.

^d Includes the income of professionals, technicians and the like.

higher among microenterprises, the latter's persistently large share of total employment would also account for much of the difference in labour incomes between wage earners in small, medium-sized and large firms, and those of microenterprises.

2. The problem in the rural sector

The 2002-2006 upswing started in the coastal regions of the country and was fuelled by an export expansion. While the economy of Metropolitan Lima began to grow later, this did not happen at all in the *sierra* or Amazon regions. It should be remembered that the rural sector still accounts for just over one third of the total EAP, and that a very high proportion of it is in the *sierra* region, where very low-productivity *minifundios* predominate. This type of "peasant microenterprise" in the *sierra* region has even less access to resources and faces greater obstacles than its urban counterparts. Accordingly, its productivity levels are extremely low; and it generally lacks infrastructure and access to markets and credit. The very small size of farms makes it hard to introduce innovations, except through associations of small-scale producers. Social and cultural patterns pose an additional constraint.

Table 3 sets out a number of indicators that put the scale of the problem in perspective. The rural sector still accounts for 34.5% of the country's total employment, which is higher than the EAP employed in Lima; but in rural zones wage-earners account for: (i) just 20.7% of total employment, compared to 50% in urban areas; (ii) 52% of self-employed workers, compared to 40% in urban areas; (iii) 25.5% of unpaid family workers, compared to 6.3% in urban areas; and (iv) average labour income equivalent to 23% of that recorded in Metropolitan Lima. As the figures shown in the table for the rural sector are averages, the situation in the rural *sierra* region is even more problematic than they indicate. Using data from the National Household Survey 2001-2004, the Ministry of Economic Affairs and Finance (2006) has estimated that 80% of economically active persons in the *sierra* region earn less than half of what is needed to buy the basic consumption basket, compared to 48% on the coast and 41% in Metropolitan Lima. All of this suggests a problem of very low productivity in the rural sector, particularly in the *sierra* region.

The current Government has initiated the *Sierra Exportadora* programme aimed at diversifying supply and attaining competitive quality and volume levels. To that end it is promoting a number of projects in which a private-sector investor enterprise coordinates with a large

number of small-scale producers, transfers knowledge and inputs to them, and markets their output. While this programme is clearly a notable step forward, whether it will bring about a large-scale change in a scenario dominated by *minifundios* with no competitive potential is an open question. In the long term, changes in the land market will probably be needed to establish the minimum area required to adopt innovations and raise productivity.

TABLE 3

Peru: labour indicators by geographic region, 2004
(Percentages)

	Urban	Metro-politan Lima	Other urban	Rural	Total
1. Unemployment rate	7.6	8.5	7.0	1.0	5.4
2. Total employment	65.5	27.0	38.5	34.5	100
3. Wage-earning employment	49.9	56.6	45.1	20.7	39.7
4. Self-employed	40.2	35.2	43.8	52.3	44.4
5. Unpaid family workers	6.3	3.5	8.3	25.5	13.0
6. Labour income ^a	788	1 062	597	233	594

Source: Ministry of Economic Affairs and Finance, on the basis of the National Household Survey 2001-2004.

^a In soles at 2004 prices.

IV

Microenterprise policy

Heterogeneity is clearly evident in nearly all domestic markets, since 97% of the country's firms are microenterprises, 2.8% are small businesses, and just 0.2% are medium-sized and large firms (MTPE/PEEL, 2007). This is reflected in glaring differences among productivity and labour incomes, depending on establishment size.

This is only one manifestation of the problem, however. What really explains such differences is the very unequal access to resources. While small, medium-sized and large firms have access to credit, are managed by a highly skilled personnel, work with trained labour, invest in fixed capital, human capital and innovations, possess information and are well placed in domestic and international markets, the opposite is true for most microenterprises. Their access to credit is limited and very expensive; only 0.1% of microenterprises export their products; their productivity and profitability does not allow them to pay for labour or management training; they lack the resources, capital and information needed to introduce innovations and invest; their market identification and participation are usually very weak, and they often have highly precarious links to local markets.

All of this also results in a very high rate of enterprise mortality —much higher than in medium-sized and large firms. Up to 80% of microenterprises close down before their third anniversary (Matthews, 2007); and 43% of those that export fail to last longer than two years (ADEX, various years). This implies a much higher risk rate among microenterprises, and commercial banks perceive this.

The very high microenterprise mortality rate is more than offset by new business start-ups. Given the rates at which these enterprises come and go, the apparent stability of statistical averages in terms of stock variables conceals significant movements in flow variables. For that reason, inflows and outflows of personnel in this segment are significant.

This has direct repercussions on the type of job and level of labour incomes that microenterprises can generate: very low productivity, low pay, and instability. This has an adverse effect on the population's welfare, given the high proportion of total employment provided by microenterprises: 53% in 2006.

Even assuming very strong future employment growth in small, medium-sized and large firms (e.g. a sustained annual rate of 8%, compared to the 5.9% per

year recorded in 2002-2006),³ together with expected EAP growth of 2.4% a year,⁴ it would take 14 years to double the share of employment in small, medium-sized and large firms, from the 17.2% recorded in 2006 to a level of 34.9% by 2020. If the empirical reference used is the National Household Survey (fourth quarters), the argument would be strengthened further. Under that scenario, the proportion of employment corresponding to microenterprises would decline somewhat, but the productivity and income gap between that segment and the others would continue to widen. This simple example suggests that in addition to seeking high employment growth in small, medium-sized and large firms, it is essential to formulate and apply productive policies to speed up the increase in microenterprise productivity and competitiveness.

It also seems highly unlikely that the boom in the Peruvian economy, which is highly sensitive to developments on external markets, will last for another 14 years; and this makes it all the more urgent to implement public policies in favour of microenterprises.

Despite the major importance of microenterprises for employment in the country, public and private policies targeting this segment in Peru are few, disperse and weak. Colombia, whose economy is 1.5 times as large, spends 12 times as much on supporting microenterprises: roughly US\$ 4 billion compared to US\$ 340 million in Peru. Similarly, in 2006, the entity responsible for microenterprise programmes —the Small Business and Microenterprise Promotion Centre (PROMPYME) integrated into the Ministry of Labour and Employment Promotion in 2007 under the name *Mi Empresa*— had an annual budget of US\$ 1.9 million to support the competitive development of this type of firm, compared to the US\$ 350 million destined for similar programmes by the Brazilian Micro and Small Business Support Service (SEBRAE), or the US\$ 50 million spent by the Production Development Corporation (CORFO) in Chile.

This article does not set out to evaluate all financial service and business development policies targeting microenterprises and small businesses in force in Peru. Only the following will be analysed: (i) the target group; (ii) informal activity; (iii) access to credit; (iv) access to labour and management training; (v) access to innovations; (vi) taxation; (vii) labour standards; and (viii) productive clusters and outsourcing.

³ According to the National Survey of Wages and Salaries in establishments with 10 or more employees.

⁴ According to the Population Division (CELADE), 2007.

1. Target group

The microenterprise segment is highly varied, encompassing units with competitive potential along with enterprises that produce for subsistence. In 2006 some 700,000 of the 2,100,000 microenterprises in existence were estimated to have competitive potential (García, 2007). Policies to promote and enhance competitiveness should target those firms if the aim is to prevent policies for this sector from serving merely as oxygen providing temporary assistance.

2. Informal activity

A critical issue in this context is economic activity performed on an unregistered basis (informality), which implies widespread evasion of regulations, i.e. the underground economy. Roughly 650,000 microenterprises and small businesses are registered with the Office of the National Superintendent of Taxation (SUNAT); but as the total is over 2.3 million, this means that 70% of these firms are “informal” *vis-à-vis* the tax authority. A similar situation is found in labour, employment, health insurance and local authority records. This raises a key issue: what policies would be needed to “formalize” a large proportion of the firms that are evading all current regulations. The answer is clear: microenterprises will only formalize when the advantages of doing so outweigh the disadvantages; and this points to the need to complement current policies with a well-designed set of measures targeting microenterprises and small business.. This article proposes a *quid pro quo*, namely give access to all the policies suggested in the following sections only to those microenterprises that “formalize”.

An essential step is to reduce the cost, time and complexity of the procedures required to set up or register a business. Progress has been made on this at the national level, although the procedures and their cost could be simplified still further. Obstacles remain at the local level, despite various local authorities having now agreed to simplify procedures and reduce the time and cost involved.

3. Access to credit

Microenterprises face two constraints in credit markets. The first is access: their credit is rationed, because the supply of credit to microenterprises is much smaller than the demand for it. The second constraint, linked to the first, is the cost of credit, which is usually between five and seven times higher than that paid by medium-sized

and large firms. According to the Superintendency of Banking, Insurance and AFPs (SBS), in late 2006 interest rates on loans to microenterprises averaged between 38% and 53%, depending on the type of loan and the financial institution in question. These figures were several times higher than the 8.2% rate on discounts for commercial loans offered by banks to larger firms at the same date. This situation has meant an increase in production costs among microenterprises, a reduction in their competitive capacity, and far fewer possibilities for investing in technology, equipment and human capital.

As a result, microenterprises are forced to lock up a larger proportion of their working capital in stocks of inputs, merchandise, or pending invoices. By holding a larger proportion of their capital in the form of current assets, they have much less capital available to acquire fixed assets (equipment) or innovations, or to invest in human capital. Consequently, the restricted access to credit for microenterprises and SMEs directly undermines factors that otherwise would have enabled them to raise their productivity.

In late 2006, financial credit to microenterprises was based on a system comprising 10 commercial banks, 13 municipal savings banks (CMS), 12 rural saving and loan associations (CRAC) and 13 microenterprise and small business development entities (EDPYMES). Of the 10 commercial banks that engaged in microfinance activities, three of them accounted for 80% of all loans: Banco de Crédito, Banco del Trabajo and Mi Banco.

According to SBS records, the outstanding balance of direct credits extended by microfinance institutions in December 2006 amounted to 4.935 billion soles, of which 2.678 billion were direct loans to microenterprises (636,000 borrowers). This figure represented 3.5% of total credit extended by the financial system to the private sector, thus giving a clear idea of the asymmetry that exists in access to credit in Peru.

Suggestions for improving the credit situation include the following: (i) use of new lending technology, already trialled in agriculture by the Development Finance Corporation (COFIDE)⁵ to promote loans to microenterprise groups; (ii) strengthening of the microfinance system; and (iii) establishment of guarantee and risk funds to promote the growth of microenterprises that have competitive potential. Expansion and updating of microenterprise records also provides much needed and useful information for entities operating in the microfinance sector.

⁵ COFIDE is a second-tier bank.

4. Access to labour and management training

The low productivity of microenterprises does not allow them to spend on labour and management training in the same way as larger firms. The available data show that average expenditure on labour training by microenterprises is 1/10 of the national average and 1/20 of the amount spent on training by medium-sized and large firms (García, 2005). Whereas 50% of medium-sized and large firms provide training for their employees, the corresponding figure is 18% in small firms and just 9.1% in microenterprises (Chacaltana, 2004). In the case of business management training, only 26% of microentrepreneurs have completed secondary education, which makes such training even more necessary for this segment. Nonetheless, only 7% of microenterprises have access to assistance services in this field, most of which deal with accounting and taxation issues rather than business management as such. At the present time, a cost-sharing system operates through vouchers (Bonopymes) issued to the microentrepreneur: the latter receives three training vouchers with discounts of up to 49 soles each, and another for assistance services with a 70% discount up to a limit of 600 soles. Nonetheless, the total number of vouchers issued is just a few thousand, so the maximum amount transferred is US\$ 200,000 per year, in circumstances where potential demand would come from 700,000 firms and amount to millions of dollars. The assistance offered by private firms that provide services and operate in this domain also does not respond to the effective demands of microenterprises, e.g. on the topics of management and productivity growth.

The suggestion is therefore to set up a fund to finance labour and management training among microenterprises and SMEs, together with an incentive in the form of a tax credit with an annual upper limit of 1.5% of the payroll. At the same time, it would be feasible to design and finance short training courses for staff in consulting firms operating with microenterprises and SMEs, focused on marketing and management in terms of productivity and quality for microenterprises.

5. Access to innovations

Sustained productivity growth depends on the firm's capacity to incorporate product and process innovations. When initial productivity levels are very low, relatively simple changes in products and processes make a major contribution. A recent example in Peru is the adoption of new simple crop-growing and irrigation techniques, which significantly raised yields and productivity in the country's

incipient export agriculture. Nonetheless, if innovations are to be incorporated, several factors are needed, such as incentives,⁶ a minimum capacity for identifying technologies available worldwide, and resources to finance their incorporation. The microenterprise segment lacks all three. Although the State has made an effort—through Technological Innovation Centres (CITEs) sponsored by the Ministry of Production—in practice it is hard to replace hundreds of thousands of private initiatives in this domain.

The voucher system mentioned above does not substantially cover the microenterprise sector, nor induce a significant change in favour of innovation among them. The alternative is to introduce cost-sharing vouchers for the purchase of innovations, together with technical assistance to incorporate them. Collective bonds can also be established for groups of microenterprises, and innovation vouchers can be combined with those corresponding to labour and management training.

6. Labour standards

In 2005, average (legal) labour costs per hour worked were US\$ 2.60 (García, 2007). This consisted of wage costs of US\$ 1.62 per hour—among the lowest in Latin America—and a non-wage labour cost of 61%, which was among the region's highest. Nonetheless, this average is not very representative of what really happens at the establishment level. In large firms, the standard labour cost per hour in 2005 was US\$ 4.95, in medium-sized firms it was US\$ 3.23, in small firms US\$ 2.81, and in microenterprises US\$ 1.29. The differences are therefore considerable; but they are even greater when the labour cost actually paid is considered rather than the legal norm, because microenterprises do not pay the minimum wage nor do they provide the benefits included in non-wage labour costs. In this case, the effective labour cost per hour in microenterprises drops to US\$ 0.80 per hour.

An initial issue is that in the bulk of microenterprises and for most employed people in the country, the legal benefits included in non-wage labour costs (vacations, health insurance, pensions, gratifications or bonuses, family allowances, length of service contribution to fund periods of unemployment, legal working week, compensation for dismissal and legal share of profits) are in practice irrelevant, because they are evaded. The

same is true for the legal minimum wage, which in 2006 amounted to 500 soles per month. The National Household Survey for the fourth quarter of 2006 showed that 60% of workers in microenterprises received a labour income below this amount. Moreover, as many of those earning above the minimum wage did so by working more than eight hours per day and on public holidays, it is easy to infer that for a very large proportion of microenterprises, the minimum wage is not applied and is evaded.

When 80% of establishments fulfil the regulations and 20% do not, one can talk of evasion and take steps to improve supervision and oversight systems. But when only 3% of establishments representing 17% of employment comply with labour regulations, and the bulk of the remaining 97% do not, it is essential to reconsider the issue and ask whether the microenterprise segment has a level of productivity that enables it to fulfil current labour standards. The regulations need to adapt to reality and not pretend otherwise. Once again, the strong productive heterogeneity that characterizes the country suggests that it is not feasible to apply the same labour standards to the microenterprise segment as to larger and more productive firms. It is also not feasible to apply the same minimum wage. A single minimum wage of 500 soles may be very high for the productivity of many microenterprises, but very low for the productivity of all medium-sized and large firms.

In fact, this was recognized in 2003 in Law 28.015, which significantly reduced the non-wage labour cost for microenterprises. Nonetheless, between 2003 and late 2007, only 40,000 microenterprises registered and became formalized under this new regime. Accepting that a large proportion of registered microenterprises have already succumbed due to the high mortality rate in their segment, today some 25,000 microenterprises would probably remain in the register, out of a total of 2.1 million, operating under the new special labour regime. This shows that it is not easy to persuade microenterprises to register under the new scheme, without implementing a set of complementary measures giving access to resources benefiting them. In other words, for a special labour regime to have the desired effects, it needs to be accompanied by complementary measures in other policy areas that allow for access to resources and raise productivity. The reason is very simple: like any other type of firm, microenterprises need profitability, demand for their products and access to resources to raise their productivity. Potential profitability can be provided by a special legal regime and/or implicit subsidies in other policies. But unless access to resources is improved, a sustained increase in the productivity and output of

⁶ The higher yield obtained from adopting an innovation tends to dissipate as other competitors follow. Consequently, an incentive is needed to equalize private and social profitability to allow innovations to spread massively.

potentially competitive microenterprises, and hence their real profitability, will remain unlikely. Special labour standards for this segment will be adopted by a larger number of microenterprises if at the same time complementary policies are formulated and applied that expand their access to resources.

This raises a crucial issue. As is well known, the labour-cost measure that is relevant for competitiveness is labour cost per unit produced, expressed in foreign currency, and not labour cost per hour. Labour cost per unit produced is defined as the ratio between labour cost per hour and hourly productivity, corrected by the exchange rate to express it in foreign currency. From this standpoint, microenterprises may have a low hourly labour cost and yet remain much less competitive than large firms if their productivity is very weak. An example can clarify this point. A large firm with a labour cost of US\$ 5 per hour and productivity of US\$ 12 per hour has a labour cost per unit produced of US\$ 0.42 per hour (5/12). A microenterprise with a labour cost of US\$ 1.29 per hour and productivity of US\$ 2.1 per hour, has a labour cost per unit produced of US\$ 0.61 per hour (1.29/2.1). Consequently, to be able to compete, it has to ignore labour standards and reduce its effective labour cost to US\$ 0.86 per hour, so that, with a productivity of US\$ 2.1 per hour, it operates with a labour cost per unit produced of US\$ 0.41 per hour, which is slightly less than that of the large firm.⁷ This example shows very clearly the importance of access to resources in raising productivity levels among microenterprises and making them more competitive.

7. Taxation

One of the reasons preventing a much larger number of microenterprises from registering in the special labour regime created in 2003 was the taxation cost they faced upon registration. If the non-wage labour cost is lowered from 61% to 30%, the total labour cost of microenterprises will be reduced by roughly 19%. Assuming that total labour costs represent 35% of total costs, the benefit provided by the special regime is equivalent to 0.19×0.35 , i.e. less than 7% of total initial costs. But on registration, the microenterprise has to start paying taxes. The general sales tax rate is 19%. Income tax, depending on the profit level and the size of the firm, will fluctuate between 5% and 14% of profits, depending

on the special regime applied (RUS or RER),⁸ which is equivalent to approximately 1.7%-5% of sales. In short, when a microenterprise registers, taxation will raise its total cost by between 21% and 24%, in return for which it will obtain a benefit of less than 7%. Even correcting expected costs and benefits for a likelihood of detection of 33% (assuming a normal statistical distribution) in the event of continuing to evade, it is not worthwhile for the microenterprise to register in the special labour regime, because the benefit provided by it is less than or equal to the costs incurred by doing so. If one adds in the backdated tax debt that the microenterprise could be charged if it is found to have been operating for several years, it is unsurprising that so few microenterprises have registered in the special labour regime.

Tax laws currently provide a special regime for small productive units, consisting of a simplification of collateral requirements—records and account books—and the way in which income tax is calculated (RER and RUS). But the situation in reality suggests that it will be essential to provide a more attractive treatment, at least for a certain period of time, if the aim is to persuade the 700,000 or 800,000 potentially competitive microenterprises to register for tax purposes as part of their formalization process.

It therefore seems essential to establish a tax incentive or credit encouraging firms to formalize, with the aim of persuading microenterprises to register for tax purposes. The Office of the National Superintendent of Taxation (SUNAT) would not lose through this, because today it is not receiving taxes from microenterprises that evade the regulations.

8. Clusters and outsourcing

In practice it is hard for a microenterprise, using its own individual resources, to finance labour and management training, innovations, organizational improvements for competitiveness, market surveys, and similar matters. It is also very difficult to implement a selective policy in favour of potentially competitive microenterprises on a case-by-case basis. Consequently, both from the microenterprise standpoint and for reasons of public policy access, a crucial issue is to promote *de facto* partnership, i.e. to promote initiatives among microentrepreneurs to form clusters based on the practical needs of their firms. This would make it possible, for example, to set up technical assistance

⁷ The exchange rate in 2006 was 3.15 soles per dollar, and this that can be used to translate the example into soles.

⁸ RUS: Single simplified regime; RER: Special income tax regime

services, labour and management training for a group of microenterprises, which would be much more viable and less costly than providing the same services case by case. The same is applicable to credit using cross-collateralization systems.

A similar scheme could be proposed for entry into more demanding markets, outsourcing, input supply for export chains, government procurement or

even export consortia. To improve chances of success, microenterprises can set up clusters enabling them to exploit the consequent economies of scale.

One way to promote partnership is to allow groups, consortia, associations or clusters of microenterprises that join, either on a *de facto* or legal basis, preferential access to the policies proposed above, thus enhancing their effects.

V

Conclusions

Over half of the active population, employed in very low-productivity and low-pay segments (urban and rural microenterprises and unskilled self-employed workers) did not enjoy any significant income growth in 2002-2006, even though they could see how the rest of the population was benefiting from the economic boom. This fact, evidenced in this analysis by the behaviour of labour markets in that period, is one of the factors explaining why in 2006 a large proportion of Peruvian voters were willing to abandon a successful economic growth model.

The Peruvian economy is essentially heterogeneous because of major differences in access to resources, which generates segmented product and factor markets. Segmented labour markets in practice operate very differently from what is assumed by economic theory developed for homogeneous markets. In such markets there are numerous obstacles, deficiencies and barriers that intermediate interactions between their various segments. In that setting, the rapid expansion of modern segments and employment and wages in small, medium-sized and large formal enterprises does not spread quickly and fully to urban and rural segments of microenterprises and unskilled self-employed workers, because: (i) rates of employment absorption in these segments remain high, which slows growth in their labour income; and (ii) microenterprises face shortcomings and access barriers in terms of the resources they need to grow competitively.

One of the features of segmented markets is that the process of adjustment in each of the segments, and its speed, differ from one to another. A given policy measure has different effects that make themselves felt at different speeds in each segment.

Economic policy is generally targeted on a country's modern and structured segments. This is appropriate, for otherwise the country would not develop. But, what happens in situations such as that prevailing in Peru, where the degree of heterogeneity and market segmentation is extremely high? What happens when 70% of the population depends on events occurring in unstructured markets? What happens when employment in small, medium-sized and large firms only accounts for 17% of total employment, and 53% of the latter is in urban and rural microenterprises? Is it sufficient to promote growth in the highest productivity and income segment? Is it sufficient, in this setting, to propose an economic policy for the more modern and structured segments, together with a social policy to combat poverty among those who depend on the functioning of the less structured segments? Events in Peru over the last 30 years tend to confirm that it is not sufficient.

It is insufficient because of the very high proportion of unskilled self-employed jobs, and particularly those in microenterprises. Accordingly, policies to raise productivity should include potentially competitive microenterprises and promote greater access to the resources they need. From this perspective, it is essential to establish, among other policies, a special labour regime for microenterprises (labour standards and minimum wage) and a special transitory taxation regime; to more vigorously promote policies to improve microenterprise access to credit, markets, labour and management training, and innovation; and above all, to encourage the various forms of microenterprise clustering and size subcontracting. Such policies should target the roughly 700,000 potentially competitive microenterprises, and provide their benefits only to those

that agree to “formalize”. As noted above, institutional changes—in labour and tax regulations—complement policies that expand access to resources. Consequently, implementing the former without the latter does not have the same chance of success as implementing both types of measure simultaneously.

Complementarity and interdependence between the policies listed is another reason for developing a set of policies in favour of microenterprises, rather than isolated actions. Thus, for example, without microenterprise management training or access to innovations, productivity growth will remain very slow; so the high microenterprise mortality rate will persist, impairing access to commercial credit. The most important thing, therefore, is to implement a set of policies that gradually but simultaneously eliminate the key constraints.

As a policy criterion, all of the measures set out above should focus on development of the respective markets—including those for training services, information and technical assistance, innovations and financial services—to gradually allow microenterprises

with higher competitive potential a better chance of accessing each of those markets. In this way, government intervention may be much more successful than direct State provision of the services in question.

The real economic policy challenge facing Peru is to design public policy measures that have the desired effect on the specific market segments being targeted. This does not mean that different economic policies have to be designed for different segments. It is more a question of incorporating into economic policy a recognition that its effects will differ between one segment and another, so the measures adopted should be able to selectively influence the different segments in the desired direction—e.g. enhancing competitiveness. This is a departure from the traditional conception of economic policy for homogeneous markets and comes closer to the reality of Peru—a heterogeneous economy with segmented markets. In other words, it moves economic policymaking away from an idealized blackboard model, and forces it to take account of the real world.

(Original: Spanish)

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