



Asia-Pacific  
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## Small and Micro Enterprise Financing: A Tool for Mainstreaming the Informal Sector?



Small and Medium Enterprise Working Group  
June 2006



**SMALL AND MICRO ENTERPRISE FINANCING:  
A Tool for Mainstreaming the Informal Sector?**

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## ACKNOWLEDGMENTS

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It is also necessary to highlight the support received from the Ministry of Foreign Affairs, the Ministry of Foreign Trade and Tourism, as well as, the contribution of Chinese Taipei, Korea, the International Labor Organization (ILO) and the Andean Corporation of Promotion (CAF).

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Finally, this publication would have not been possible without the collaboration of: Ivan Mifflin, Mauricio Osorio, Vanessa Banchemo, Manuel Tong, Julio Bravo, Carlos Ferraro, Karin Talavera, Ines Pando, Silvia Borda, Ambassador Juan Carlos Capuñay, and Julissa Sotil, who edited and compiled the presentations of the symposium for this publication.





# INTRODUCTION

## INTRODUCTION

Since the early 1980s, the informal sector constituted by poor people who live outside of the formal economy has gained greater importance. Informality is not a new concept and nowadays, it is a topic of current analysis that seeks to include income generation activities that are carried out by the underground economy and also allow the population equal access to opportunities. For this reason, during the last decades, the Agenda for development of APEC economies has been oriented to identify policies and strategies aimed at overcoming informality. The informality problem has been discussed in the political, economic and academic fields where there is a wide consensus of its complexity and depth. The main question is why informality exists and how to face it? For developing economies, it is of great importance to find answers to this question especially for poor people that live in the informal sector and have small enterprises both in the rural areas as well as in urban poor areas that scarcely allow them to survive. These activities are carried in traditional sectors with low productivity where entry barriers do not exist.

Small scale enterprises start their operations before they are legally constituted mainly due to the high costs, both legal and/or administrative procedures. This influences directly in the process for formalization of these enterprises and especially, its assets. In developed economies business formalization is the starting point of any business. In developing economies, this happens when business growth makes it impossible for them to keep on growing without being «legally constituted.»

Informality limits businesses in several different aspects such as access to market opportunities and services, legal stability, property rights and recognition of assets value. By not having these elements, the growth of the enterprise is restricted; productivity is limited; and this prevents the improvement of labor conditions and respect of labor legislation.

The main causes that enterprises cannot access financial resources are: first, lack of necessary guarantees or in some cases their assets cannot be used as collateral; second, they do not have proper book keeping or adequate managerial information.

Many of these enterprises are informal because their operation or assets are not registered properly. But the problem is even more complex, because there is asymmetric information. In other words, financial institutions (especially, the microbanking and microfinance institutions) cannot determine, with the information available, how profitable is the enterprise and according to this, grant the requested loans. Also, there is qualitative uncertainty, because is not possible to determine the certainty of revenues and debt payment. Finally, there is the perception of moral hazard which also constitutes a barrier for financing.

For the financial sector, it is very difficult to facilitate the access to financial resources for the informal sector, especially, when they do not have information about potential creditors or where credit risk is almost impossible to determine; in other words, information on other creditors is not known. However, in the last years, there has been a proliferation of microfinance institutions that have been able to provide services to small enterprises that were not necessarily formal enterprises. This has been through field work and the use of new financial technologies that has allowed them to minimize risks. The use of social networks provided information on creditors and allowed them to reduce interest rates. These institutions are giving more value to the creditor's behavior and financial culture, and have started the process of building their creditors financial record.

As this practice becomes more generalized and more institutions provide loans in the microfinance market, which is highly profitable, there will be more competition and more financial services available, the interest rate will be reduced. These schemes can also become a powerful motivation for formalization as these enterprises could be capitalized and grow.

In this sense, this publication constitutes a compilation of the presentations from the Symposium «Formalization and Financing of Micro and Small Enterprise: the Experience in APEC Region» that was part of the APEC Project «Micro and Small Enterprise financing: to tool for mainstreaming the informal sector?» of Small and Medium Enterprise Work Group (SMEWG).

The main objective of the Symposium and this document is to continue the debate of this subject and to find mechanisms in the region in order to promote formality and access to financing of small scale enterprises. In this sense, this document intends at finding some answers to the following questions:

To what extent, does the lack of formalization constitute a barrier for micro and small enterprise to access financing?

What is the impact of the microfinance in business formalization?

What are the benefits and costs of business formalization?

What is the relationship between formality and financing?

For this purpose, this publication is divided into four sections:

### **Panel 1- Business Formalization: Regulatory Framework**

This panel explores existing strategies to support informal sector, as well as the barriers that do not allow business formalization. The approaches of International Organizations such as International Labor Organization will be presented, as well as, the experiences of Chile and Peru.

### **Panel 2- Costs and Benefits of Business Formalization in the APEC Region**

The benefits and costs of being formal are detailed in this panel. The approaches of the International Financial Corporation (IFC) from the World Bank, as well as, experiences of Mexico, People's Republic of China and Russia are presented. In addition, this panel includes the business case studies of Kola Real and Grupo Rocio.

### **Panel 3 - Mechanisms and Strategies to Promote the Financing**

This panel shows the different mechanisms and strategies to promote financing such as micro credits, start-up loans, guarantee funds and commercial banking. It also describes micro credits, guarantee funds schemes and programs that are being implemented in different

economies. The programs of the Small Business Administration of the USA, Andean Corporation of Promotion (CAF) and financing schemes of South Korea, Peru and Chinese Taipei are presented.

#### **Panel 4 - Relationship between Formalization and Financing**

This panel shows the survey results on formalization and financing in the APEC region and the paper elaborated by the consultant Mr. Fernando Villaran, former Minister of Labor and Employment Promotion of Peru. Likewise, information on formalization and financing and their relationship are included. The objective is to propose future actions to contribute formalization and facilitate access to financing.

Finally, as mentioned lines above, the informal sector or underground economy has called attention of analysts, governments and academicians. This is not exclusive to Peru for it is a problem shared by many developing economies. Everyone knows the effects that informality causes in our economy (e.g. ambulatory selling, micro enterprise of survival, tax evasion, underemployment, among others) and considering the complexity and importance of this problem, it is necessary to have policies and strategies aimed at reducing the informal sector and which are able to incorporate the excluded and underprivileged into the formal economy.

Therefore, informality is a current topic in the Policy Agenda of APEC economies. Considering that each economy has different conditions, it is very important to exchange information on best practices on appropriate mechanisms that facilitate formalization and access to financial services for Micro and Small Enterprises. Promoting entrepreneurship and business development is a requirement for incorporating the informal sector. We hope you enjoy this publication and that it is useful for future initiatives to foster Business Formalization.





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## PANEL I:

### REGULATORY FRAMEWORK FORMALIZATION

**Theme:** «FROM INFORMALITY TO MODERNITY»

**Mr. Victor Tokman**, Advisor to the Chilean Presidential Office, former Regional Director for Latin America of ILO, expert on formalization, Chile.

**Theme:** «FORMALIZATION OF THE MICRO AND SMALL ENTERPRISES IN PERU»

**Mr. Carlos Espinoza Alegria**, Former Vice Minister of Employment Promotion and MSEs, Ministry of Labor and Employment Promotion, Peru.

**Theme:** «LEGISLATIVE AGENDA FOR THE PROMOTION OF MICRO AND SMALL ENTERPRISES IN CHILE»

**Mr. Gabriel Corcuera**, Advisor to the Productive Development Division of the Ministry of Economy, Chile

# FROM INFORMALITY TO MODERNITY

Mr. Victor Tokman

## 1. Why Should the Informal Sector be Promoted?

Nowadays, there is a generalized agreement about the need to pay attention to the informal sector both due to its importance in relation with employment, as well as, for its relation with poverty. Moreover, there are an increasing number of programs oriented to support informal activities with similar characteristics in various economies.

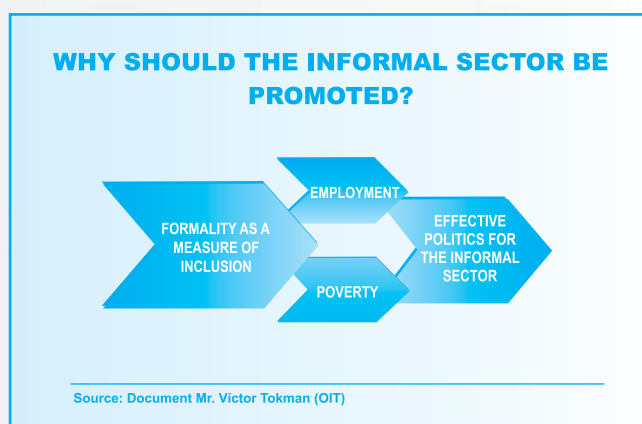
The informal sector must be promoted for the following reasons:

- **Employment**
- **Poverty**
- **Possible effective policies for the informal sector.**

Regarding employment, the importance of the informal sector in terms of employment creation is quite evident. By 1997, approximately 50 percent of Latin America's jobs were generated from informal activities and it is still increasing. In the last decade, seven out of every ten new jobs that have been generated come from the informal sector.

In addition, the informal sector is a key component to respond to the problem of poverty and indigence, as well as, to support the most vulnerable sectors, specially women and children. Six out of every ten poor people and almost seven out of every ten indigents, are in the informal sector.

Presently, there is more political support for the informal sector. These measures or policies are made in high-level hierarchical governmental levels. There is an increasing acceptance, and even, active participation, in some cases, from the society and especially from enterprises and unions. This acceptance is based in the evidence that promotion policies of the informal sector are possible even in economically restrictive times because they are profitable when they are managed appropriately and have International Cooperation financial support.



Graph N° 1  
Why Should the Informal Sector Be Promoted?

## 2. What Is Understood By Informal Sector?

The concept or idea of «Informal Sector» is introduced in 1972 in the International Labor Organization (ILO) report. The conceptual definition consisted in highlighting what happens in economies of relatively low development. The employment problem is concentrated not much in the unemployment per se, but mainly in those that being employed receive an insufficient income; the ones denominated «working poor». These people develop low-productivity activities, although they are functional to the rest of the economy.

A second definition most recently developed which comes from the 80's, was focused in the more increasing separation between workers and the enforcement of labor laws. The different ways of productive insertion, in turn, define a heterogenic group that requires policies of differential treatment.

The work performed by Hernando de Soto (1986) adds to the informality situation, the inadequate government intervention and a group of regulations, laws, and procedures that does not allow the appropriate development of enterprises. He emphasizes that in the majority of developing economies, the legislation was multiple and contradictory, which resulted in a bureaucratic state that did not allow or restrict the change to formality of small scale enterprises. This situation is still present.

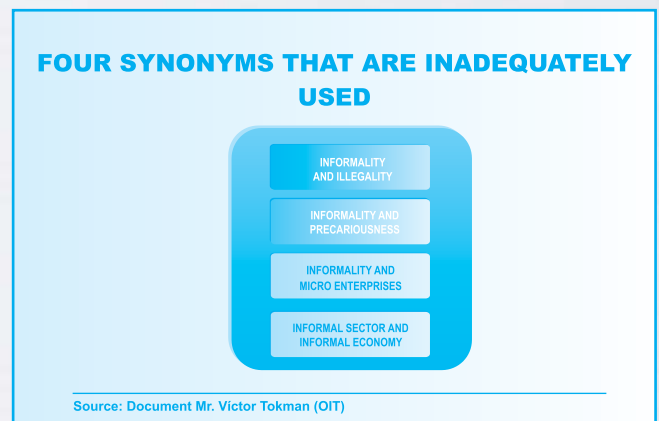
An additional definition, although not substitutive, of informality is the one approved by the ILO International Labor Conference in 2002. To the definition of «informal sector», defined from the characteristics of productive units, it is added the concept of «informal economy», which includes the first, but also involves those people working in formal businesses whose labor relation does not provide them with labor and social protection.

### 3. Four Synonyms That Are Inadequately Used

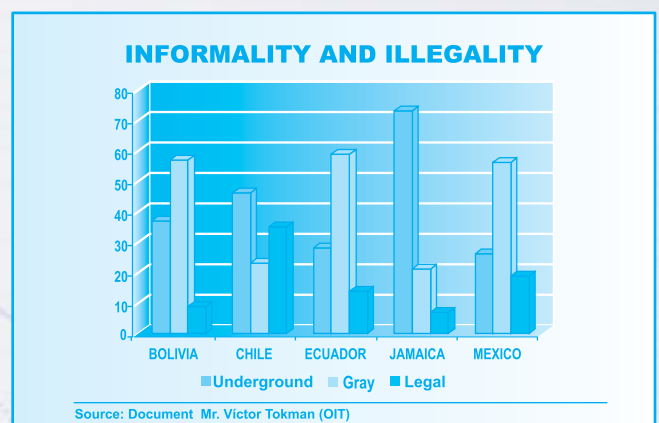
The word «informality» tends to be used incorrectly with terms like: legality, precariousness, micro enterprises and informal economy. In some cases, the use of this terminology provides a confusion that prevents the effective development of appropriate governmental policies, and in other cases, its effect is harmless.

#### 3.1 Informality and Illegality

Illegality presents various important and predominant shades or «gray areas» that are located between absolute legality and absolute illegality. Those «gray areas» are composed of enterprises that perform a partial fulfillment of some legal or



Graph N° 2  
Four Synonyms that are Inadequately Used



Graph N° 3  
Informality and Illegality

procedural requirements and perform some modification to those requirements. These businesses keep as strategy the minimization of any eventual sanction costs, either penalty fees or bribes, by complying with some requirements provided by the law and procedures, particularly in those economies with minimal fiscal discipline and reduced control capacity.

### 3.2 Informality and Precariousness

The issue of precariousness has a direct relationship with the percentage of the Economically Active Population (EAP) that does not have contracts or are under temporary or non-conventional contracts.

Due to labor reform, the possibility of hiring workers under a determined duration and subject to a higher degree of precariousness has increased, due either to occupational instability that they involve or to the reduction, lawful or de facto, of the degree of labor and social protection.



Graph Nº 4  
Informality and Precariousness

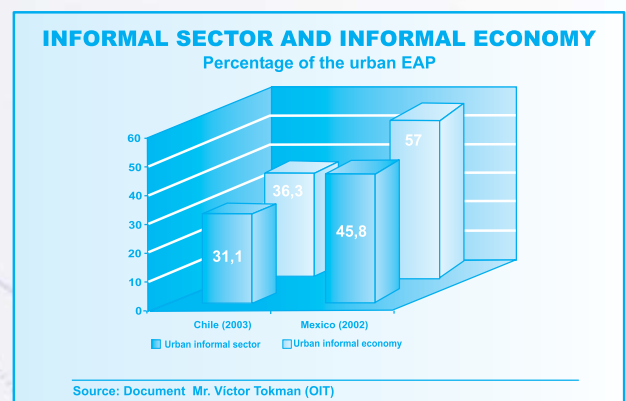
Therefore, within the labor field, there is an accumulation of non-declared jobs and precarious jobs, both concepts usually identified with informality. The existence of precarious contracts is of general use and that does not necessarily reflect informality but evasion or, in some cases, the use of enabled instruments by the labor laws. As it can be seen in the previous graph, in average, approximately 65 percent of the workers in micro enterprises in Ecuador, Chile, Colombia and Peru did not have a contract or were under a precarious situation. Such percentages vary from over 70 percent in Peru to around 40 percent in Chile.

### 3.3 Informality and Micro Enterprises

There is an overlapping between the concepts of informality and micro enterprises, as the numbers show. The percentages of micro enterprises that pay some of the current taxes are significantly much higher. Thus, in Peru in 1996, 94 percent of micro enterprises paid some of their taxes; in Chile (1990) around 70 percent of the micro enterprises with five or less employees and 96 percent of those with more than five employees paid the property tax and value added tax (sales tax). In Ecuador, the property tax was paid by 78 percent of micro enterprises and by 94 percent of those with larger size; while 54 and 81 percent, respectively, paid the value added tax.

### 3.4 Informal Sector and Informal Economy

The concept of Informal Economy is a contribution of ILO. This concept is more complete and allows determining policies



Graph Nº 5  
Informal Sector and Informal Economy

that increase the degree of protection of the workers employed in large enterprises; these policies differ substantially from those applied to the small enterprises.

#### 4. What Policies Are Recommended?

Informality and the generation of micro enterprises are solutions that arise in economies that have not been able to generate productive employment in a sufficient manner. There are no simple and automatic recipes to solve the informality problem. The trend is to search for the missing link that generally is associated with capital. About this particular topic a lot of work has been done and there is a great experience, something that is good for developing economies.

The integration of the informal sector to the process of modernization can be achieved by different non-exclusive ways. The policies that prevail with this orientation are generally viewed in the following three dimensions:

- Productive Support
- Social Policies of Social Welfare
- Simplified Regulatory Environment

The first dimension is the support that seeks to foster the productive development of micro enterprises, facilitating their access to credit programs, training, and more dynamic markets through the promotion of organization and commercialization.

The second dimension refers to the development of social welfare for the workers employed in the informal sector. Here is where social welfare policies tend to get confused with anti-poverty policies. However, an aspect to be considered is that in small scale productive units, the family and business appear some how intertwined. The lack of coverage on social welfare is an obstacle to the proper economic performance, mainly, in health and housing. Therefore, there are positive externalities by complementing policies that are oriented to social welfare and that generate a positive interaction with the micro enterprises and productive development.

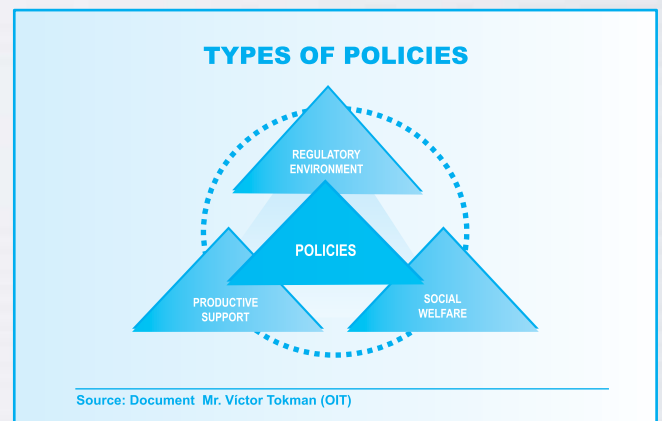
Finally, a third dimension is aimed at the institutional regulatory framework. Although the informal activities are not a result of an inadequate regulatory framework; this must not lead to not acknowledging that the correction of regulatory inadequacies favors the integration of informal activities to modernization.

#### 5. From Informality to Formality

The perspective proposed changes the emphasis. It is proposed to shift the prevailing emphasis on obligations to an emphasis based on rights, since these are instrumental to progress and

IT IS INCORRECT TO ASSUME THAT BECAUSE ACCESS TO CAPITAL MICRO ENTERPRISES IS FACILITATED, THEIR PROBLEMS ARE SOLVED. THE SOLUTION REQUIRES SOLID MACROECONOMIC POLICY, FOSTERING THE DEVELOPMENT AND GENERATION OF GOOD JOB POSITIONS.

THERE ARE NO SIMPLE OR AUTOMATIC RECIPES.



Graph N° 6  
Types of Policies

development. The implementation of these rights may generate virtuous circles. This, definitely, may constitute the necessary incentive so that people that are in the informal sector become also the main interested in these efforts for formalization.

IT IS NECESSARY THAT PEOPLE IN THE INFORMAL SECTOR ARE INTERESTED IN BECOMING FORMALIZED, IN ORDER TO ESTABLISH SUSTAINABLE POLICIES IN TIME.

## 6. Specific Regulation or Special Regimes for the Informal Sector?

A first option to consider is to define a special regulatory system applied to the informal sector. This implies the introduction of dual or preferential systems. In general, there are several arguments that point out the inconvenience of accepting this differentiation, specifically those that refer to fiscal (tributary) and commercial considerations, and mainly, to labor relations.

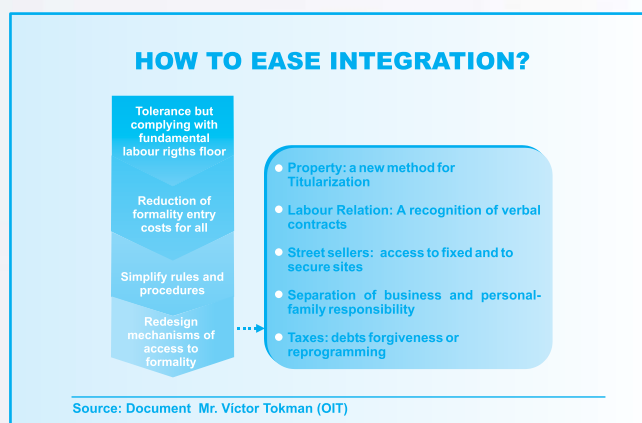
In the tributary field, the establishment of non-taxable minimal levels or systems of simplified declarations, or tax calculations based on presumable basis; constitute in fact a differential treatment, as an option not to be discarded. With relation to financial themes, duality is possible, for example, the introduction of loan programs with preferential rates, which is considered viable in many economies.

In the labor field, it implies to accept a differential treatment to the workers before the law; depending on what size of enterprises they are employed in. Thus and particularly referred to the labor field, the preference is for a specific system. This is one of the ways usually followed in area of labor laws, where the legal requirements constitute objectives to reach and where the degree of progress towards the objectives fulfillment constitute an area of monitoring and control.

## 7. How to facilitate the integration?

In the labor field, a tolerance with certain limitation must be established, as well as an effort to comply with labor legislation; but the commitment that this is done starting with a set of fundamental labor laws. This is the position that ILO adopted at beginning of the 90's. These rights are: human rights from the standpoint of the labor field; and the recognition of collective rights that are the essence of democracy, such as the right of association, the right of collective negotiation, non discrimination, the abolition of slavery and child labor. In addition, subjects on hygiene and security have been incorporated in Free Trade Agreements.

Another mechanism is the reduction of entrance costs to formality. There is a certain awareness about the rigidity of the legislation, even though there have been reforms in several economies, which is important. Some economies have taken policies of administrative silence that revert the delay. This means that if the administrative authority does not answer on a determined period, the procedure is assumed as accepted.



Graph N° 7  
How To Ease Integration?

THE SIMPLIFICATION OF RULES AND PROCEDURES, THROUGH THE USE OF INSTRUMENTS SUCH AS: A ONE STOP SHOP, A UNIFIED AUTHORITY, AS LONG AS IT IS VIABLE, IT WOULD TEND TO MINIMIZE THE COSTS OF FORMALIZATION.

Another great contribution is e-government and the introduction of Internet as a mechanism of information and facilitation of the procedures.

Also, there are mechanisms of formalization. A mechanism of growing spread, suggested originally by Hernando de Soto (1995), refers to the acknowledgment of the property title as a mechanism to loan access. The innovation proposed consists in simplifying the procedure of entitlement that recognizes the property legally and adequate it to the «de facto» ownership. This means to depart from contractual requirements and ownership demonstration, by alternative methods of recognition, like the possession (long-time use), the recognition by witness (neighbors in the case of houses or lots) and the cleansing of conflictive interests. The entitlement responds in this way as one of the barriers to loan access, since the requirement of establishing real warranties, generally supported by ownership, and excludes sectors whose «property» is not formalized.

Another instrument that may be modified with the same objective refers to the recognition of the labor relationship. In Peru, for example, 90 percent of the labor contracts in the informal activities are not written, and with that this indispensable requisite is left aside to have access to the laws of labor promotion. There is, however, a verbal contract that should be recognized as an alternative, without having to force a jurisdictional figure to the existing one, through the monthly use of a notebook by the employer, or by the presence of witnesses that assure the relation of job or the fulfillment of schedule, or the presentation of bills for salary payments. This will allow «to formalize» the labor relation, the first step necessary to incorporate the regulated relations.

Street vending deserves a special treatment. In this case, the strategy to apply should be conciliating the right of the people to the use of public space and the right of the vendors to perform a stable job that generates income. Although this activity must be regulated by the legal and labor regulatory framework, the strategy of formalization and modernization to be applied must consider also specific components to the sector.

- First, the access to property or renting lots in which they can install and perform their commercial activity within the framework of municipal ordinances.
- Second, to adequate the offer of available lots to carry out commercial activity to the plans of public transportation regularization so that people can easily access to these commercial centers.
- Third, promote the organization of street vendors in a market, and other markets so that scale economies may be achieved which make their investment profitable.

Another tool is the division of property between the person's property and the enterprise's property (of great importance also for the micro enterprises) which are obtained generally through the constitution of societies of different legal nature and degree of complexity. For example, in Peru, there are societies of limited responsibility and specifically, the introduction of the Individual Enterprise of Limited Responsibility (IELR). The requirements associated to the latter are simple, but crucial in the transformation of property responsibility of the micro enterprises.

Finally, control campaigns directed to the informal sector tend to justify themselves in terms of a need to broaden the tributary base, diminish the evasion and sanction illegality. It is known that the cost of these campaigns generally do not justify the expected tax collection (in Peru, according to SUNAT<sup>1</sup>, each additional «sol» collected requires an

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<sup>1</sup> Peruvian Tax Authority



administrative spending of 0.75 soles), and on the other hand, the importance of the incorporation of the informal activity as a corporate tax payer is that it induces as a first consequence to the generation of accounting information. This, in turn, constitutes an indispensable requisite for business development because otherwise, the micro enterprise is not allowed to perform its economic calculations, and therefore, it lacks a key instrument to optimize its business administration.

## 8. Additional Components for a Strategy

A fundamental change is required in the micro entrepreneurs' behavior, which implies a cultural change. This is about contributing to generate new attitudes and behaviors that allow the development of micro enterprises and those that work there, in a more appropriate environment to reach success. The small enterprise has resource flexibility. From individualism, that is associated with the history of growing by one's own means within the framework of a savage competition, to the culture of working together, since there are advantages in group production and in market penetration.

There must be a change from family businesses to enterprises with a formal labor relation. The paternalistic mentality of the entrepreneur must be changed by leaving aside the personal relations and starting market-level ones.

The proposal that is performed is a necessary condition, although not enough, to access to modernization. Definitely, modernization adds an additional dimension, those of rights and a different orientation, the one of building an economic citizenship.

THERE IS A GREAT CHALLENGE TO LINK THE SMALL ENTERPRISE AND THE INFORMAL ACTIVITY WITH THE MORE DYNAMIC MARKETS. IT IS NOT POSSIBLE TO CONTINUE OPERATING WITH THE SURVIVAL OF POOR COMPANIES FOR POOR MARKETS. THE RESULT OF THIS IS THE SURVIVAL WITH LOW LEVELS OF INCOME.



# Conclusions

## 9. Conclusions

- The integration of the formal sector to the modernization process can be reached through productive support, sector policies of social welfare and a simple regulatory environment.
- To achieve formalization it is necessary to have a fundamental change in the entrepreneur's behavior, meaning a cultural change.
- These are mechanisms to facilitate integration: keep labor tolerance but respecting the fundamental work rights, formality entry cost reduction, have simple rules and procedures, and redesign mechanisms that ease the access to formality regarding award of property titles, street vending, taxing and verbal contracts.

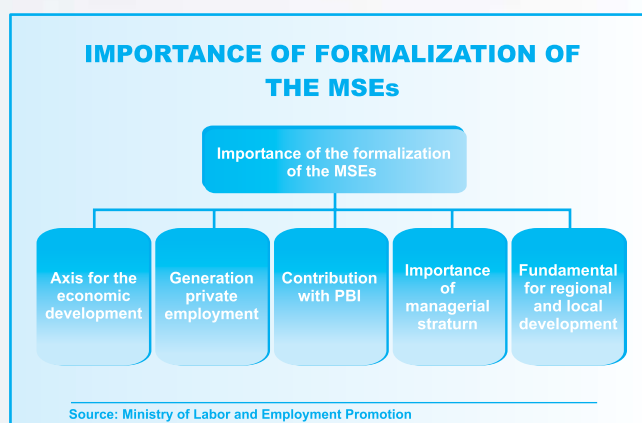


# FORMALIZATION OF THE MICRO AND SMALL ENTERPRISES IN PERU

M<sup>a</sup> Carlos Espinoza Alegría

## 1. Importance of Formalization of the Micro and Small Enterprises (MSEs) in Peru

The Ministry of Labor and Employment Promotion (MLEP) is the enforcing entity of the Micro and Small Enterprises (MSEs) in Peru. This sector in 2004 contributed with 42 percent of Gross Domestic Product (GDP) and generated 88 percent of the private employment is the one that requires formalization. In Peru, 98 percent of the economic units are micro and small enterprises (micro enterprises represent the 94.4 percent and small enterprises 3.9 percent.), which convert in a driving agent in the local, regional, and national economy, and in a crucial factor for economic development and employment generation.



Graph N° 8  
Importance of Formalization of the MSEs

According to statistics, the Peruvian Tax Administration Authority (SUNAT) and the National Farming Census, the hierarchization by sales of different economic strata, is as follows:

- A micro enterprise is defined as having annual sales below US \$150,000,
- A small enterprise is defined as having annual sales between US \$150,000 and 850,000,
- A medium enterprise and large enterprise are defined as having annual sales over US\$ 850,000.

These criteria are valid in Peru according to the Law on «Promotion and Formalization of Micro and Small Enterprise» (Law N° 28015). Each one of the above segments has an intrinsic subdivision. For example, some authors describe survival micro enterprise, as one that has annual sales below US \$42,000. It is necessary to have these subdivisions clear in order to develop new strategies and that are aimed more adequately and realistically.

Participation of the MSE in the Economy			
Type of Enterprise	N° of Business		Business 2004
	Year 2001	Year 2002	
Micro Enterprise	467001	622209	94.40%
Small Enterprise	35075	25939	3.90%
Medium and Large Enterprises	7348	10899	1.7%
Total	509424	659046	100.00%

Source: Sunat and III National Farming Census (CENAGRO 1994)

Table N° 1  
Participation of the MSE in the Economy

In Peru, 76.8 percent of micro enterprises are in the services and commerce sectors; whereas 16 percent is in the industry sector. This can be observed in following the graph.

It is estimated that there are 2'500,000 enterprises, but only 648,000 are formal. A formal enterprise is defined as one that pays its taxes to the tax authority, in this case, SUNAT. In Table N° 2, the number of formal and informal enterprises is shown in the economic strata of MSEs.

In the following figure, 75 percent of micro enterprises nationwide are informal. In the segment of small enterprises, this situation is reversed: 62.8 percent of small enterprises are formal. This confirms that as the sales and number of workers employed grows, it provides incentives for formalization. The opposite happens when sales are low, there is a lack of such incentives and additionally, the costs related to formalization are higher.

## 2. Strategies to Formalize the MSEs in Peru

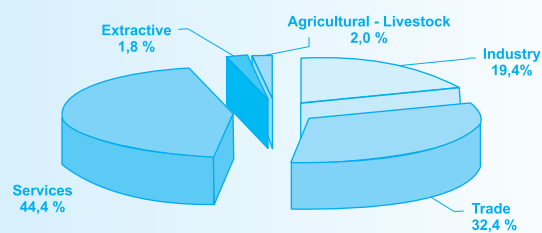
The Ministry of Labor and Employment Promotion (MLEP) has been developing a group of strategies defined within a program framework established by law. The main objective is to foster the development of MSEs, keeping in mind that this development is oriented towards the generation of dignified employment<sup>2</sup>. This is achieved through the improvement of the capacity of employment and labor insertion, and also through the promotion of small and micro enterprises.

It is also the role of the MLEP to establish the general policies and promotion rules of the MSEs that allow the development of processes for their adequate insertion in the national economy, as well as to facilitate the business formalization through the development of

<sup>2</sup> Dignified employment is one that the employee receives a salary that allows him/her to satisfy his/her basic needs and enjoy minimal necessary social services.

### MICRO ENTERPRISES ACCORDING TO ECONOMIC SECTORS

Micro Enterprises According to Economic Sectors  
NOV. 90 – MAY. 2005



Source: SUNAT 2005, INEI 2002

Graph N° 9  
Micro Enterprises According to Economic Sectors

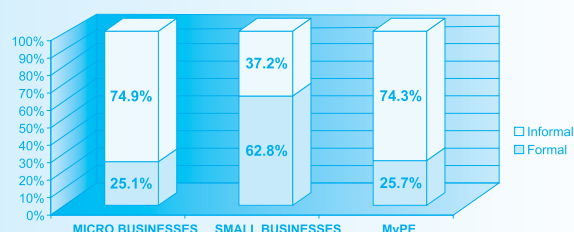
### MSE! FORMAL VERSUS INFORMAL

Participation of MSEs in the Economy			
Type of Enterprises	N° Enterprises		
	Formality	Informality	Total
Micro Enterprises	622209	1855075	2477284
Small Enterprises	25938	15395	41333
MSEs	648147	1870470	2518617

Source: Document Mr. Victor Tokman (OIT)  
Elaboration: Study of DNMyPE and PROMPyME

Table N° 2  
MSE Formal versus Informal

### PERCENTAGE OF M&SB FORMAL AND INFORMAL MSEs - 2004



Source: SUNAT 2005, ENAHO 2002 - INEI

Graph N° 10  
Percentage of Formal and Informal MSEs - 2004

### STRATEGIES FOR MLEP



Source: Ministry of Labor and Employment Promotion

Graph N° 11  
Strategies for MLEP

two fundamental components:

- Regulatory Component
- Promotional Component

The regulatory component is in charge of promoting the creation of regulations that allows the effective compliance to formalization laws, like Law N° 28015, enacted in 2003, and to carry out actions that allows the complying of these regulation.

This law is of great importance, since in it MSEs are defined, its main features and institutional framework are established. In the latter, the MLEP is designated as the regulatory entity, the National Council for the Development of the MSEs (CODEMYPES) as the national instance, and in each region, Regional Councils are established. In addition, laws related to the Law on Promotion and Formalization of MSEs were identified.

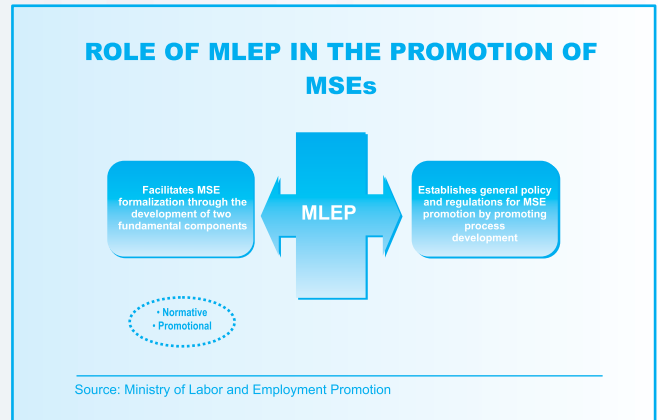
The promotional component consists in the implementation of actions that favor MSE development by providing assistance in the following fields:

- Technical Assistance
- Training
- Organization and Advertising
- Administrative Simplification Processes

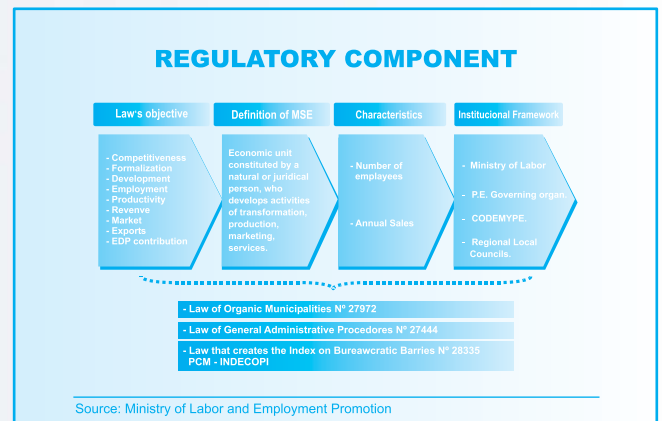
### 3. Achievements of the Formalization Program (PRODAME) of the MLEP

Since 1990, there is a program called PRODAME. This program is oriented to fostering employment and income generation through the assistance in the legal constitution of MSEs and their business associations. It supports them with simple procedures, time reduction and formalization costs. Moreover, it facilitates MSEs' access to business development services, the government procurement system and financial resources of the formal system. The PRODAME program does not only facilitate discounts and promotional prices, but also provides subsidies for formalization.

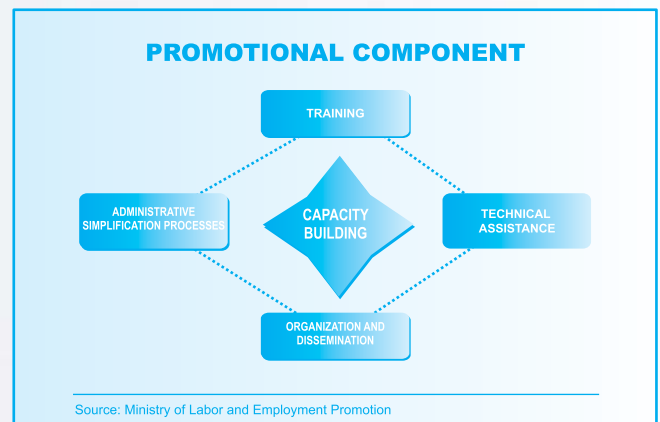
There are two ways to perform businesses in



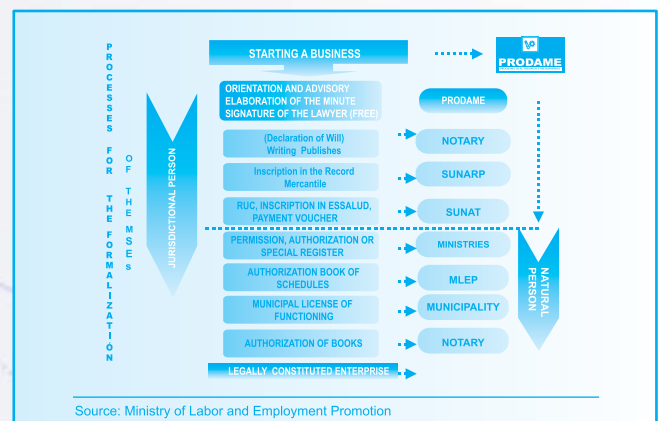
Graph N° 12  
Role of the MLEP in the Promotion of the MSEs



Graph N° 13  
Regulatory Component



Graph N° 14  
Promotional Component



Graph N° 15  
Processes for the Formalization of the MSEs

Peru: as a natural person and jurisdictional enterprise (artificial person). The PRODAME works in both instances in the different steps, as shown in figure ° 15.

The results and progress of formalization lead to 41,000 enterprises were established and 233,000 users were serviced. The PRODAME program does not only provide services to enterprises, but also associations and federations. The statistics of the program are presented in Figure ° 3.

This figure shows the success of the program. Since 2002 there has been a sustainable growth in employment and in the number of established enterprises.

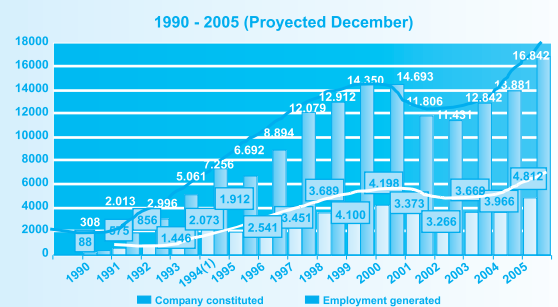
## PROGRESS IN MSE FORMALIZATION

Progress in MSE Formalization	
□ Variables	1990 - 2005 (May)
□ Attended users	233,877
□ Constitutions of micro and small enterprises	41,253
□ Training events Numbers of trainings	5,202 268,044
□ MSE Associations	212
□ RENAMYPE	66

Source: Ministry of Labor and Employment Promotion

Table N° 3  
Progress in MSE Formalization

## PERU: PROGRAMMES FOR SELF EMPLOYMENT AND MICRO ENTERPRISES



Source: Ministry of Labor and Employment Promotion

Graph N° 16  
Peru: Programmes for Self employment and Micro Enterprises

# Conclusions

## 4. Conclusions

- The process of easing MSE formalization can be achieved through work in two complementary components, the promotional component and regulatory component.
- The promotional component must be focused toward technical assistance, training, organization and dissemination, as well as the establishment of simpler administrative procedures (reducing red tape).

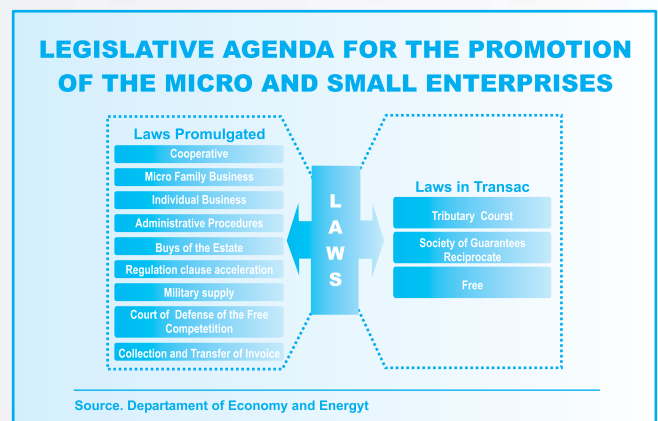
# LEGISLATIVE AGENDA FOR THE PROMOTION OF MICRO AND SMALL ENTERPRISES IN CHILE

Gabriel Corcuera

In Chile, approximately 40 percent of all enterprises are micro enterprises of which 30 percent are informal. In 2000, the president made the decision to apply reforms to the model in place, with the objective to achieve the year 2010 development goal.

To meet this objective, a modification of the current laws to allow these enterprises to achieve formalization was conceived. In order to attain these reforms, a national consultation to small and medium businessman was done, which later became in a statute project for the small enterprises. In this project, important reforms were proposed to the already existing laws, as well as the creation of new laws.

To this date, 9 laws have been enacted, and there are still three more law proposals under review in Congress. These are shown in the following graph.



Source. Department of Economy and Energyt

Graph N° 17  
Legislative Agenda for the Promotion of the Micro and Small Enterprises

One of the laws that had an important impact was the Law N° 19832, Law on the Family Owned Micro enterprise. This law establishes that a micro entrepreneur that carries economic activities in their own house can obtain a municipal permit and other formalization procedures with only registering in the municipality, without complex procedures, fulfilling simple requirements.

AT THE BEGINNING, ENTREPRENEURS DID NOT USE THE LAW BECAUSE THEY SAID «THE SYSTEM WAS SO SIMPLE THAT THEY DID NOT BELIEVE IT WAS POSSIBLE.»

In order for the model to be successful, it was necessary to establish clearly the benefits of legality. This is why it is important to consider as benefits the access to a series of promotion instruments like training, technical assistance and financing.

In the following table, the laws enacted are shown; including the date of publication, its objective and the main advantages in the process for formalization in Chile.

Table Nº 4:  
Legislative Agenda for the Promotion of Micro and Small Enterprises

Laws enacted	Publication date in the Official Journal	Objective	Advantages
Law Nº 19.832 Law on Cooperatives	November 4 <sup>th</sup> 2002	The objective is to allow that small and medium enterprises have a powerful instrument to develop joint projects, that allow them to boost their possibilities to compete, manufacture and obtain financing, in national and international markets. It modifies the General Law on Cooperatives in Chile.	<ul style="list-style-type: none"> <li>Cooperatives can be profit-oriented.</li> <li>It facilitates the acquisition of jurisdictional personality.</li> <li>It reduced the minimum number of enterprises required to constitute a cooperative.</li> <li>New mechanisms for conflict resolution are established.</li> <li>It expands the operations that savings and loans cooperatives can develop in the financial market.</li> <li>It establishes broad supervision and regulation powers in the Department for Cooperatives of the Ministry of Economics.</li> </ul>
Law Nº 19.749 Law on Family Owned Micro Enterprises.	August 25 <sup>th</sup> 2001	The objective is to provide benefits to micro enterprises that are located in the entrepreneur's household. <ul style="list-style-type: none"> <li>The Law indicates that micro enterprises that carry out economic activities in their own home, may obtain a municipal patent (permit) and other formalization procedures only by registering in the municipality without complying with regular requirements such as zoning and sanitary requirements.</li> <li>The Law recognizes that there are 400.000 enterprises that operate in households and are for subsistence purposes. The idea is to assist them so they keep progressing by only requesting them to register they are automatically given the start of their activities by the Internal Revenue Service (IRS)</li> </ul>	<p>It allows an enterprise to become formal without complying any other requirement (e.g. zoning) except those that elaborate or process food that require a simplified authorization.</p> <p><b>REQUIREMENTS:</b></p> <ol style="list-style-type: none"> <li>The entrepreneur must be the legitimate occupant of the household.</li> <li>The productive assets excluding fixed assets do not exceed 1000 UF (US\$ 30000).</li> <li>The number of non family member employees does not exceed 5 employees.</li> <li>The activity must not be disturbing, contaminating or dangerous.</li> </ol> <p>A simple sworn affidavit to accredit compliance of these requirements is requested. No documents or certificates or required.</p>
Law Nº 19.886 Law on Government Procurement	June 30 <sup>th</sup> 2003	<ul style="list-style-type: none"> <li>It achieves that the purchase processes are more transparent, accessible and efficient. (During 2004, US\$ 1900 million were carried out and 30% of the sales were from micro and small enterprises)</li> <li>It creates 2 related institutions: <ol style="list-style-type: none"> <li>Direction of Government Procurement (Chile Compra <a href="http://www.chile.compra.cl">www.chile.compra.cl</a>)</li> <li>Court on Government Procurement</li> </ol> </li> </ul>	<p>The Government Procurement procedures are established. For small enterprises there is an opportunity to participate but they must take training and must associate with other small enterprises. Any interested party may register as a Government provider and has access to all information on purchase requests and awarding.</p>
Law Nº 19.924, Law on Military Supplies	January 9 <sup>th</sup> 2002	<ul style="list-style-type: none"> <li>It allows that the goods that are bought by the armed forces such as apparel and footwear are purchased in Chile.</li> </ul>	<ul style="list-style-type: none"> <li>It fosters the development of small enterprises by generating jobs.</li> </ul>
Law Nº 19.911, Law on the Defense Court for Free Competition	November 14 <sup>th</sup> 2003	<ul style="list-style-type: none"> <li>It creates the Defense Court for Free Competition which will have a special and independent nature.</li> </ul>	<ul style="list-style-type: none"> <li>Also, the expenses, that the armed forces undertake, stay in Chile's small enterprises.</li> <li>The Defense Court for Free Competition will have the jurisdictional function that will correct, prohibit and repress actions against free competition.</li> <li>It may know upon a request of the National Economic Public Attorney the situations that may constitute Law infractions.</li> <li>It may know upon a request of the Public Prosecutor or another person on non-contenting matters that may infringe Law dispositions.</li> <li>It may dictate general instructions. It may propose to the President of the Republic the enactment, modification or derogation of legal precepts or related regulations.</li> </ul>



# Conclusions

## 1. Conclusions

- To establish a legislative agenda to foster MSE is a necessary measure for the formalization process.
- The Law on Family Owned Micro Enterprise in Chile was not elaborated with the purpose of fostering formalization but instead observing a universe of enterprises that were informal. This law allows enterprises that are currently operating to register and to access promotion mechanisms like technical assistance, training and financing.

## PANEL II:

### COSTS AND BENEFITS OF BUSINESS FORMALIZATION IN THE APEC REGION

- Theme:** ELIMINATING BUREAUCRATIC BARRIERS FOR FORMALIZATION.  
Mrs. Anita Bathia, General Manager IFC for Latin America and the Caribbean (LAC - Facility)
- Theme:** THE INFORMAL BUSINESS IN MEXICO: COSTS AND BENEFITS.  
Mr. Gustavo Melendez Arreola, Director for Financing Channels Development and Business Growth, Mexico.
- Theme:** THE ROLE OF THE SOCIAL NETWORKS IN THE FORMALIZATION AND ECONOMIC DEVELOPMENT OF ENTERPRISES: CONTRASTING ROUTES CHOSEN BY RURAL PEOPLE'S REPUBLIC OF CHINA AND A FORMER SOVIET REPUBLIC  
Mr. André Everett, Department of Management, University of Otago, Zealand.
- Theme:** DEVELOPMENT OF THE MICROFINANCE SYSTEM IN RUSSIA  
Mr. Veniamin Kaganov, President of the Academy for Management and Market, Russia.

#### Business Case Studies

##### KOLA REAL

Mr. Alfredo Paredes, Director of Corporate Image, AJEGROUP, Mexico.

##### GRUPO ROCIO

Mr. Rafael Quevedo, CEO, Grupo Rocio, Peru.

# ELIMINATING BUREAUCRATIC BARRIERS FOR FORMALIZATION

Anita Bathia

The International Finance Corporation (IFC) was created in 1956 and is part of the World Bank Group. It is the major source of multilateral investment funds for private enterprises in developing economies, and is present in 175 world economies. The IFC has an integrated strategy of investment and technical assistance; this generates added value to its operations. Within the strategic priorities of IFC are: investment, development, and promotion, and these can be observed in more detail in Table N° 5

The IFC has offices of technical assistance in eleven economies, in which approximately 90 million US dollars have been invested, of which 30 million US dollars are IFC funds for South America, whose headquarters are in Lima, Peru.

The areas of approach of IFC are basically the improvement of the business conditions, reinforcement of the local benefits of the investment performed by the IFC, and support to the entrepreneurial competitiveness.

## IFC's STRATEGIC PRIORITIES

Strategic priorities of the IFC	
Invest	In low income or high risk economies.
Develop	Local financial markets.
Establish	Long lasting collaboration relation ship with the clients.
Promote	Private participation in infrastructure health and education.
Be a Leader	In corporate social responsibility (Sustainable)

Source : Presentation Mrs. Anita Bathia "Eliminating Bureaucrats Barriers for the formalization"

Table N° 5  
IFC's Strategic Priorities

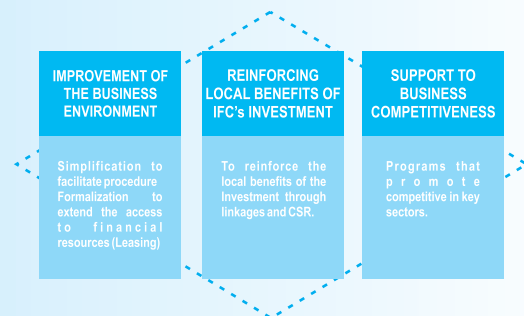
## IFC's OFFICES IN THE WORLD



Source: Presentation Mrs. Anita Bathia "Eliminating Bureaucratic Barriers for the Formalization"

Graph N° 18  
IFC's Offices in the World

## APPROACH AREAS



Graph N° 19  
Approach Areas

## 1. Why is it Necessary to Work on Reducing Bureaucratic Barriers to Investment?

International Studies have determined that bureaucratic barriers are one of the five most important obstacles for MSE development in Latin America. Bureaucratic barriers limit the possibilities to enter the formal market.

In the graph 20, the relationship between competitiveness and entry barriers are shown; economies with high entry barriers have low competitiveness indexes.

Another interesting analysis is to establish the relationship between bureaucratic barriers and the corruption perception amongst businessmen. There is a direct relationship between these two variables. This has an impact on the investment decisions and on government policies.

Bureaucratic barriers and the corruption perception contribute to informality which affects both the enterprises and the economy. Enterprises do not have access to financing, they cannot innovate and mainly their commercial acts are limited and therefore their growth is also limited.

The impact of informality for the state is of great importance not only because it loses funds from taxes, but also because it loses control over the economic activity of entrepreneurial strata representative of some economies.

## 2. Entrepreneurs' Perception Regarding Formality

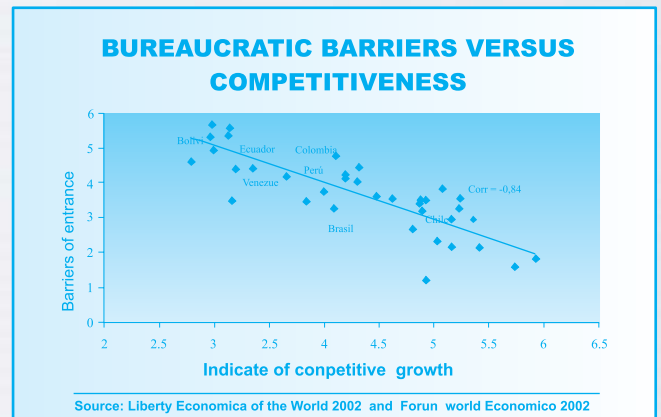
When entrepreneurs are asked the question, why would your enterprise be formal? They answer the following:

- To have contracts with large businesses and be able to perform larger commercial activities.
- To have access to formal financing (loans).
- To protect themselves from irregularities and overrun due to corruption.

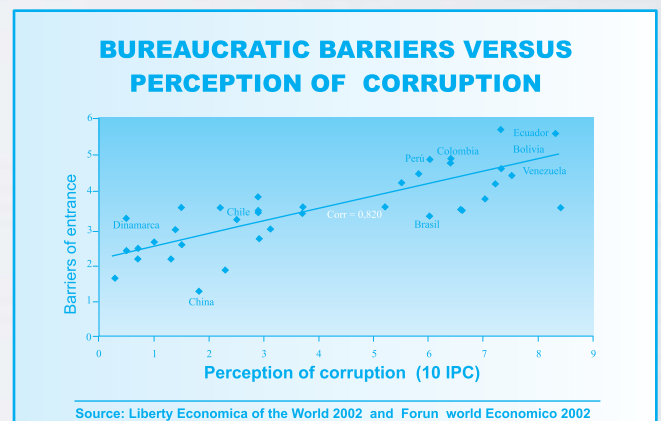
In order to have an international benchmark, annually the World Bank Group publishes the «Doing Business» report that measures the level of governmental regulations in more than 140 economies (including APEC economies) and analyzes which is their effect in the business environment.

## 3. How Bureaucratic is the Paperwork to Open a business in APEC?

Generally, in the APEC economies are less bureaucratic than in the rest of the World but it



Graph N° 20  
Bureaucratic Barriers Versus Competitiveness

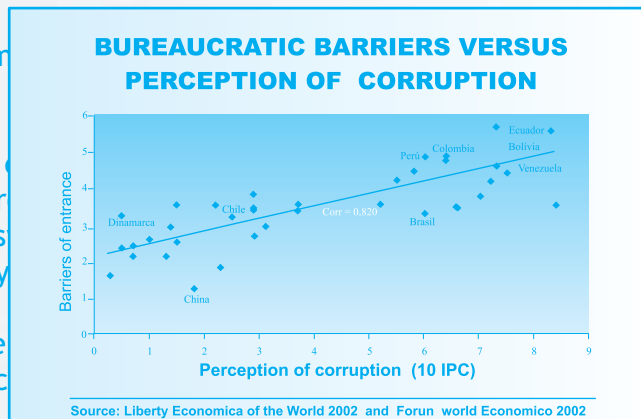


Graph N° 21  
Bureaucratic Barriers Versus Perception of Corruption

is not always a rule. In economies like Peru, 98 times more than in Australia<sup>3</sup>. The level of inform of procedures required.

The Province of Ontario, Canada is a remarkable be reduced. Since July 2002, the federal and pr into a One Stop Shop. The results of the new s register electronically an enterprise in only 3 day

Recently, the Australian government created the public-private commission denominated the «effic of business register procedures to only 2 days.



Graph Nº 22  
How Bureaucratic are transactions in APEC?

#### 4. Where is it Necessary to Improve?

Peru is, without a doubt, one of the economies that more efforts have done in simplifying procedures since the last decade. IFC has supported Peru in creating of Laws, Decrees, and Unified Text of Administrative Procedures (TUPA), promoting the reduction of requisites and steps, but despite these efforts, today Peru is one of the most bureaucratic economies of APEC. Until now, integration between the national and municipal government has not been achieved and there are serious problems in the sustainability of reforms mainly because the private sector is not involved in those reforms.

**THE KEY FACTORS FOR THE REFORM ARE THE INTEGRATION OF THE PROCEDURES, THE REENGINEERING OF THE PROCESSES AND A JOINT WORK BETWEEN THE PUBLIC AND PRIVATE SECTOR.**

#### 5. In Peru, is it a Central Government or Municipal Government Problem?

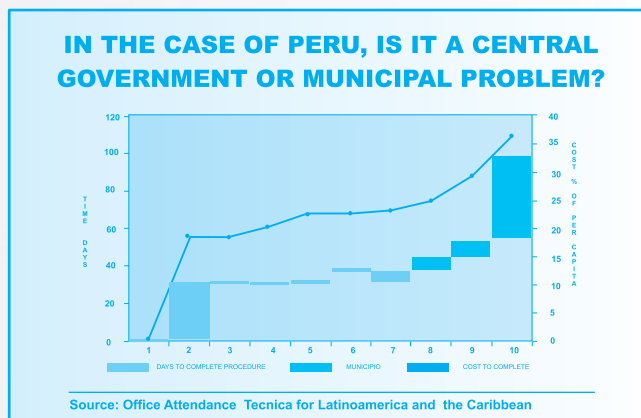
Approximately 50 percent of the time related in opening an enterprise is invested in obtaining of the Municipal License. There are statistical evidences that 65 percent of the accusations related to bureaucratic barriers that INDECOPI gets, are related to municipal procedures.

Considering this, in the Metropolitan Municipality of Lima, the implementation of a pilot project on simplification of procedures has been initiated. The Project is currently in the process of consolidation of a public-private inter institutional network that prompts a national strategy of simplification of procedures at the municipal level.

#### 6. Technical Assistance for the Procedure Simplification

IFC’s technical assistance on simplification of procedures is performed through a methodological scheme in four stages:

- Diagnosis



Graph Nº 23  
In the case of Peru, is it a Central Government or Municipal Problem?

<sup>3</sup> Doing Business 2004

- Simplification Procedures Proposal
  - Implementation
- Monitoring, Follow-up and Continuous Improvement.

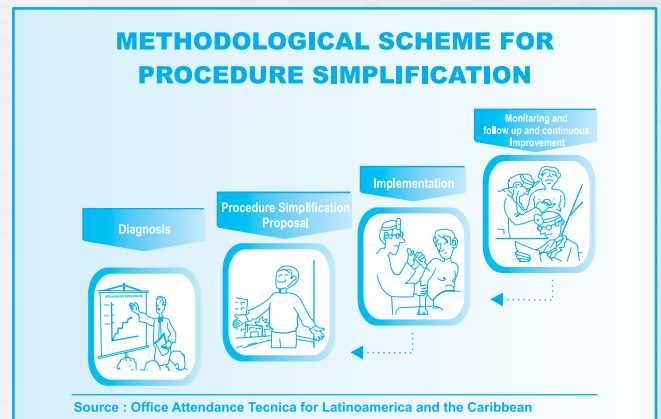
During the diagnosis stage, the need is identified; the necessary institutional support is evaluated for the development and sustainability of the project. Also, the implementing agency, that demonstrates the necessary capacities and the required experience, is identified.

Next, the proposal for procedure simplification is analyzed, approved and implemented. Finally, the follow-up and supervision to the fulfillment of the specified tasks is performed, the good practices are systematized to define new pilots and support for sustainability.

## 7. Key Factors for Success

The key factors for success in these processes of change and simplification are determined by:

- Political Support
- Institutional Support
- Internal and External Awareness Raising
- Joint Elaboration
- Appropriate Strategy for Implementation
- Effective Implementation, not only a Proposal



Graph N° 24  
Methodological Scheme for Procedure Simplification

Sustainability is a critical component in the implemented reforms; therefore it is necessary an adequate awareness raising and a permanent training process

## 8. Tools that Accompany the Reforms

The main tools that accompany the reforms for simplification of procedures are:

- The systematization of good practices, through the development of a Toolkit for the Simplification of Municipal Procedures. This will allow promoting the administrative simplification process in a massive way and also it is a training instrument.
- Continuous system of measurement over the bureaucracy at a municipal level or a Municipal Development Scorecard: this will allow to carry out an adequate follow-up of the reforms and to generate a healthy competition to attain more efficiency.

SUSTAINABILITY IS A CRITICAL COMPONENT IN THE PROJECTS. IT IS NECESSARY THAT THE IMPLEMENTING AGENCY AND THE BENEFICIARIES MUST MAKE THE REFORMS THEIR OWN. ALSO, AN ACTIVE PARTICIPATION OF PRIVATE SECTOR SHOULD BE ACHIEVED.

# Conclusions

## 9. Conclusions

- The key factors for reform are the integration of procedures, process reengineering, and joint work between private and public sector.
- Sustainability is a critical component in projects so it is necessary that the implementing agency and beneficiaries appropriate the reforms, and to get the active participation of the private sector.
- The success factors in these change processes and simplification are:
  - Political support.
  - Institutional support.
  - Internal and external awareness raising.
  - Joint elaboration
  - Adequate implementation strategy.
  - Implementation.

# INFORMAL ENTERPRISES IN MEXICO: COSTS AND BENEFITS

Gustavo Melendez Arreola

## 1.- General Background of Informality in Mexico

In Mexico, around 11 million people participate in small scale productive activities, generally in informal businesses. This represents 27 percent of the employed people of the economy, the majority of them in the non-structured sector. The non-structured sector in Mexico is one that does not have labor contracts for its employees, social security, and does not pay taxes.

Almost five million micro enterprises occupied less than 15 employees, being the average three employees per enterprise. The characteristics of these enterprises are the following:

- Their workers have less education and training
- They do not have adequate tools, equipment or machinery
- They operate with less efficient techniques and administration
- Their productive processes and products are traditional
- They service less diversified markets and with less purchasing power
- They lack adequate stores or business locations
- The net earnings are generally low
- They do not have access to commercial banking

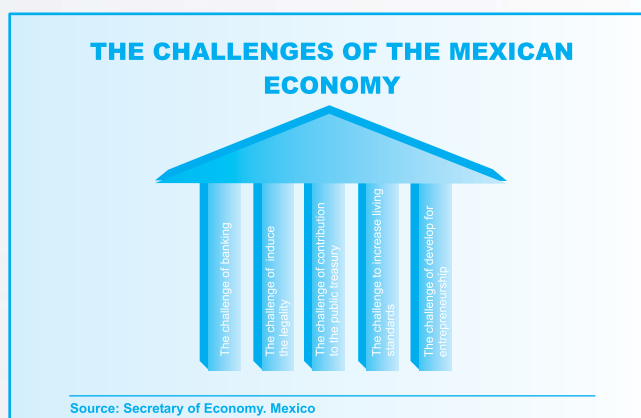
Only 700,000 enterprises with less than 15 employees are registered in the Mexican Institute of Social Security, however, its importance is unquestionable, particularly in the employment generation. Nevertheless, formal employment in Mexico grew in 2005 at a rate of 2.9 percent; the unemployment rate also grew, reaching 4.2 percent of the Economically Active Population (EAP).

Therefore, the objective is to transform the non-structured sector and articulate the rest of the economy, hence five particular challenges aimed to trigger and raise the economic development of the Mexican economy are determined.



## 2.- The Five Challenges of the Mexican Economy

In Mexico, five challenges were determined to foster the social and economic development, resulting from the considerable occupation of people in the non-structured sector of the economy. These are shown in Graph N° 25.



Graph N° 25  
The Challenges of the Mexican Economy

### 2.1 The Challenge to Increase Living Standards.

The low income that is generally paid in the non-structured sector means that the employees and their families barely fulfill their basic necessities. The improvement in the living standards of these economic strata is slow and in the long run, this generates limitations in their social and human development.

### 2.2. The Challenge to Induce Legality.

Under the excuse of low and uncertain income, informal enterprises follow in the non-compliance of several legal obligations, and it becomes quite complex to fulfill excessive paperwork having small structures. Additionally, non-compliance is greater in certain activities with low expectancy life.

A GREAT PROBLEM IS THE TRADE OF STOLEN, COUNTERFEIT OR SMUGGLED ITEMS, THESE NEW BUSINESSES HAVE CREATED NON-FORMAL BUSINESS STRUCTURES FOR ITS OPERATION.

### 2.3 The Challenge of Contributions to the Public Treasury

Although the Mexican Tax Legislation has included special tax regimes for small business; the non-compliance of fiscal obligations is generalized; it is estimated that one of every three enterprises pay taxes. The lack of income in the public sector limits the instrumentation of support programs for the smallest businesses.

### 2.4 The Challenge to Develop Entrepreneurship

This is the most important of all challenges. In more developed and competitive economies, entrepreneurial competition is impelled and education is oriented towards the acquisition of necessary attitudes for the identification of investment opportunities

BOOSTING ENTREPRENEURSHIP ALLOWS TO RECEIVE BENEFITS SUCH AS THE EMPLOYMENT GENERATION AND ENTERPRISE CREATION, MORE PRODUCT SUPPLY, DEVELOPMENT OF SUPPLIERS, INTEGRATION OF PRODUCTIVE CHAINS, TECHNICAL ADVANCES AND INNOVATION, ALL OF THESE MECHANISMS RAISE THE LEVEL OF COMPETITIVENESS OF THE ECONOMIES

### 2.5 The Challenge of Banking

There is a great difficulty to access financing for non-formal enterprises mainly because their income is low and uncertain, and they lack sufficient warranties. There is a survival risk of this type of enterprises. In this panorama, enterprises search for alternative sources of financing, presenting options like informal financial

enterprises with high interest rates. Even in the micro financing programs, the cost of money is elevated.

### 3.- What Can Be Done?

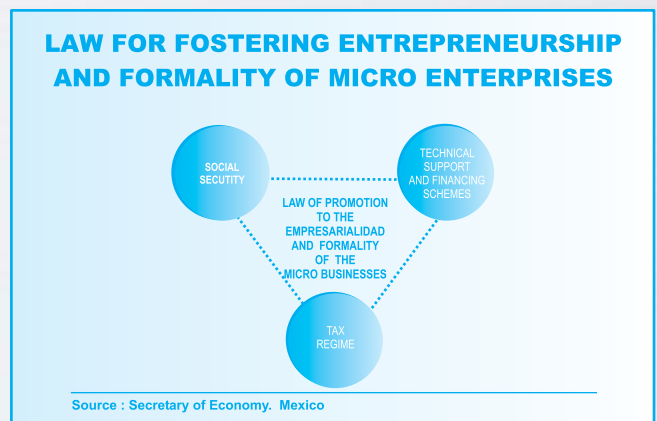
In order to transform the non-structured sector and to articulate it within the productive activity, it is necessary:

- To recognize the current conditions and its importance
- To create the necessary incentives, but at the same time apply all the force of the law towards illegal activities
- To act and behave in an integral way particularly with jurisdictional support.
- To use financing as an instrument to promote formalization of enterprises, and
- To develop entrepreneurship and new businesses.

### 4.- Legal Aspects: Law for Fostering Entrepreneurship and Formality of Micro Enterprises.

Although structural changes are not given by decree, it is fundamental to adapt the current legislation to promote entrepreneurship and formality of micro enterprises; this does not mean softening the current laws to favor this sector, nor establishing indiscriminate subsidies, but to formulate advantages and support that tend to equalize the conditions of these enterprises to those of bigger size.

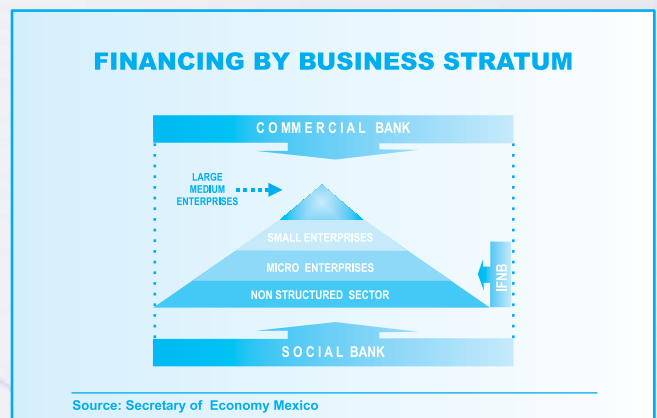
The Law of Promotion of Entrepreneurship and Formality of Micro business is currently under debate by the Mexican Congress; this law evaluates the aspects like social security, the fiscal regime, and the technical support and financing schemes, all of this in an administrative simplification framework and of use of information technologies, as can be observed in Graph N° 26.



Graph N° 26  
Law for Fostering Entrepreneurship and Formality of Micro Enterprises

### 5.- Financing Programs in the Mexican Economy

Regarding financing and considering the pyramid shown in the attached figure, it is observed that the commercial banking service is in the upper portion of the pyramid. For the non-structured sectors, there are micro financing programs, and it is been searched that non-banking financial intermediaries access with theses instruments to small and micro enterprises segments.



Graph N° 27  
Financing By Business Stratum

Hence, the strategy of financing is divided into three segments which are: formal enterprises, non-formal enterprises and entrepreneurs.

For formal enterprises, a National Financing Program for Micro Enterprises has been designed. For non-formal enterprises, there is the National Financing System for SMEs; while for entrepreneurs, a Program for Start-ups is being developed. This is shown schematically in Graph N° 28.

The schemes for entrepreneurial financing and their principal characteristics are shown in Table N° 6.

Regarding entrepreneurship, there is a lag because until recently there was no mechanism to finance this type of enterprises in Mexico. There were some attempts to work with commercial banks but it encountered resistance, and for this reason, a Program Start-ups was developed. This program found its support in the National System of Incubators. This program allows that the financing to new undertakings is carried out through business incubators. The economic resources come from a fund generated by the Federal Government.

The goal is that enterprises are financed through micro finance institutions, and those that are financed by programs for start-ups may graduate the system and in the near future, become eligible for loans from commercial banking.

## 6. National Financing System for SMEs

The National Financing System for SMEs is directed to the non-formal sector, this allows developing financing channels and products. The strategy of the system is centered in offering guarantees, financial instruments, managerial and advisory services. The following figure shows the strategies of the National Financing Program for SMEs.

## 7. National Financing Program for Micro Enterprises

The National Financing Program for Micro Enterprises (PRONAFIM) carries the following actions:

- To create the conditions that allows the access to loans to people and groups with low resources for the self-employment and development of productive projects.



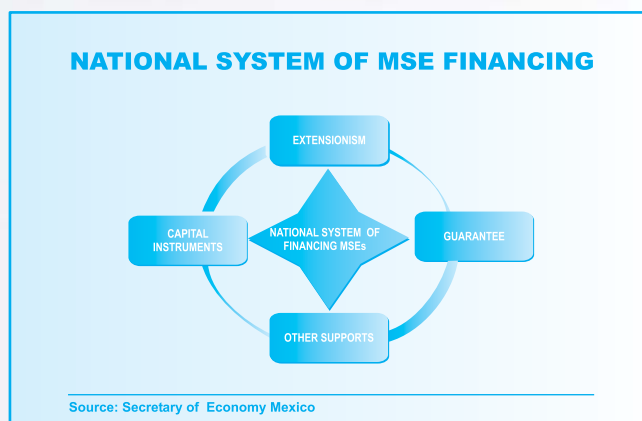
Graph N° 28  
Financing Program in Mexico

The table outlines the schemes of enterprise financing, categorized into **INFORMAL ENTERPRISE**, **FORMAL ENTERPRISE**, and **ENTREPRENEURS**.

INFORMAL ENTERPRISE	FORMAL ENTERPRISE	ENTREPRENEURS
Microfinance	Banks and IFNG loans up to 300 thousands USD.	Few options of financing.
Credits even 3 Thousand USD.	Interest 20 % under levels of rate portfolio.	National system is developed.
Annual interest rate 60 % under of overdue levels portfolio.	OVERDUE PUBLIC POLICY GUARANTY	PUBLIC POLICY: START UP FUND
PUBLIC POLICY FUNDING		

Source: Secretary of Economy Mexico

Table N° 6  
Schemes of Enterprise Financing

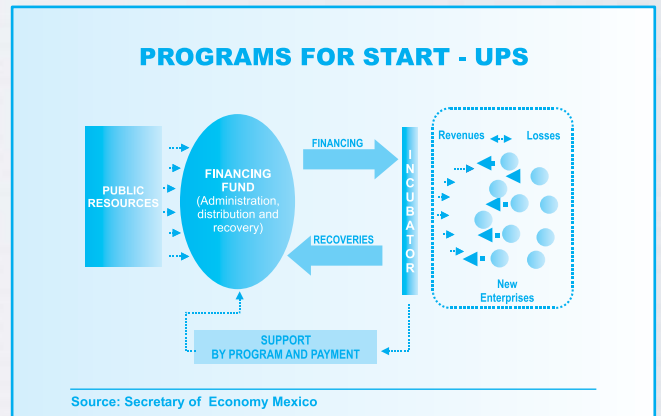


Graph N° 29  
National System of MSE Financing

- To provide non-recoverable support for the creation of institutions of micro financing and the establishment of branches of such institutions.
- To offer training and human development of managerial and operation personnel of the micro finance institutions.

### 8. Program for Start -Ups

The Program for Start-ups is oriented for entrepreneurs. It provides resources to businesses incubators that have the best models of entrepreneurial development. See graph N° 30.



Graph N° 30  
Programs for Start-ups

# Conclusions

## 9. Conclusions

- Informality generates costs and benefits, therefore the formalization process should give a positive and sustainable balance.
- It is important to work on the effects of the non - structured economy, but it is more important to attack the causes that generate it.

# THE ROLE OF SOCIAL NETWORKS IN FORMALIZATION AND ECONOMIC DEVELOPMENT OF ENTERPRISES: CONTRASTING ROUTES CHOSEN BY RURAL PEOPLE'S REPUBLIC OF CHINA AND A FORMER SOVIET REPUBLIC

Mr. Andre Everett

## 1. Research Background

The research carried out in this study examines the impact over the economic changes and the transition economies of the different social networks, making parallels between the situation of the former Soviet Republic of Kyrgyzstan and the rural province of Hubei in China. The proposed thesis is that extended networks of cooperation are not new schemes of administration, but on the contrary, they are recognized models over which any organization can operate satisfactorily in a free market.

This concept of extended networks needs to be seen as a result of a particular or social organization, considering that the voluntary association is free of state influence. In turn, this trend towards the voluntary association has a necessary conditioning factor: the existence of adequate funds of social capital that promotes confidence and cooperation between people, that otherwise would not be related. The type of organization called «People and Village Enterprises» (PVE) provide evidences of dynamic social networks in rural China.

## 2. Economic Liberalization: State Owned Enterprises and Rural China <sup>4</sup>

The answer to economic liberalization of state businesses in China has been slow and partitioned. Most of them have been sold or incorporated to form joint businesses with foreign investors. These are currently fighting to keep their viability against the labor force, inefficient administration, inherited structures of a dominant economic era, and of high levels of debt. On the other hand, the field has been dominant in the social and economic reform, opening to investment and to external and internal commerce growth.

In the 1978-1984 periods, the PVEs in the province of Zhejiang were increased to 32 percent; in 1993, part of the economic activity had increased to the point that the PVE's produced 73 percent of the province's GDP, providing 67 percent of the province tax collection<sup>5</sup>, the PVEs represented 60 percent of China exports in 2000<sup>6</sup>.

<sup>4</sup> Malcom H. Cone & André M. Everett

<sup>5</sup> Forster, 1997:253.

<sup>6</sup> Li, 2001.

### 3. Case Study: The Steel Rods Business in Hubei Hanchuan.<sup>7</sup>

Two years after the national reform of 1979, the Steel Rods Business was founded with six partners, five of the village Duanjia and one from a neighboring village in the province of Hubei - China. Before 1988, this enterprise had grown, resulting in the creation of the Steel Rods Business of Hubei - Hanchuan, with the extensive action between residents of the villages and more formal relations with the political and local financing community. The village of Duanjia has a history in forging iron and metals of more than 500 years.

In the 80's, the iron industry flourished, that allows the growth of the rods enterprise of Hubei - Hanchuan, extending the enterprise to a molding plant of steel and a brick factory before 1986. Each family in the village was involved in forging and elaboration of iron before 1986. The fame of the village and its iron produces extended through the county. Parallel to these cooperative progress, a lot of people established small private businesses, also related in the processing and marketing of iron, these businesses employed up to seven or eight people, generally immediate family members or those of the founder, this brought the anger of the provincial government that was willing to repress the flourishing of these capitalist trends.

The Steel Rods Business of Hubei - Hanchuan (HSW) started as a private enterprise of limited responsibility. The potential of the enterprise translated in a growth that required a substantial investment (coming from foreign capital) and attracted without a doubt negative attention of the government.

The solution under the state's perception was to convert their enterprise in the government most preferred form, the organization of an enterprise of the «people and the village». The HSW enterprise was officially founded as PVE in 1988, as a shared business having as partners all the residents of the village of Duanjia.

Under the direction of the partners, the business flourished with new technologies, acquired from official loans allowed for its condition as a PVE. HSW emerged as a regional industry leader. In 1994, its total income was 200 million Yuan (approximately US\$ 25 million) with earnings and tax payments of more than 20 million of Yuan.

In 1997, the enterprise was in the stock market, with half of the stocks reserved for the original partners of the village; this gave an infusion of fresh money that was invested in real state and biotechnology research. Before 2001, the business had 3,500 employees and resources for a value of 1.7 billion Yuan.

As the steel work grew, its founders got prestige, allowing them to influence the direction of local political parties. In Duanjia, the businesspeople were not interested in having public office for themselves, but they were content of controlling the formation of a leader group and to be active in supporting candidates to the Mayor's Office toward those that had a good disposition towards their interests.

The CEO insisted that the triumph of the business had been very important in the reconstruction of the community. He identified the need of improving roads, schools, and taking care of the residents' health, several projects were developed like: the construction

<sup>7</sup>Malcom H. Cone & Andre M. Everett

of residencies for poor senior citizens, the establishment of a retirement fund, as well as an insurance fund for all the members of the community.

The central point of the study of HSW was the nature of the property of the organization and its impact on the extended network of cooperation. HSW originated as a voluntary association between six founding businesspeople, who visualized this enterprise as a cooperative approach to ensure a satisfactory sustain for themselves and their direct families.

The second main decision in the existence of HSW was the conversion of a family owned business of six partners into a communitarian property of the people and the village, this would have represented in theory a fundamental rupture with the extended network of cooperation that created it, however, this was not the case. The change decision was made swiftly, almost with a sense of inevitability, and in a very pragmatic way. The network would be extended, from six families to an entire village; the common benefit was assimilated and accepted.

In the PVE's in China, a high level of cooperation between themselves was found (when it could have been treated as a competitor) in the commercialization of its products and ensured the resources for its operations.<sup>8</sup>

IT IS INTERESTING TO NOTE THAT THE BEHAVIOR OF THE WORK NETWORKS IS ANOTHER EXAMPLE OF THE COMPLEX BEHAVIOR OF THE ENTREPRENEURIAL ORGANIZATION IN THE CHINESE SOCIETY.

COOPERATION BASED ON THE MUTUAL IS THE KEY FOR THE SUCCESS OF THE ORGANIZATION

#### 4. The Rebirth of Confucian Values in the Entrepreneurial Environment<sup>9</sup>

Won identified the values of pragmatism, «family values», autonomy and personal trust, as necessary ingredients for the entrepreneurial activities in the Chinese style. He observes that this is selective, and it is occurring predominantly in rural areas of China, where 60 percent of this population live. The Confucian values are reappearing there first and lead to the private and collective sector (PVB) to then dominate the Chinese economy.

The economist Weitzman in 1994 proposes that the Chinese society has a good disposition towards cooperation. This cooperative spirit starts from a pragmatic evaluation made by Chinese entrepreneurs, and as a significant strategy to ensure the benefits of a growing economy for them and for their families.

THE COOPERATIVISM IN CHINA IS ANALOGOUS TO THE LAWS IN THE WEST, WHILE FAMILY AND RELATIVES IS ANALOGOUS TO INDIVIDUALISM IN THE WEST. AS LAW, COOPERATIVISM SERVES AS A FORCE TO GUARANTEE CREDIBILITY IN THE BEHAVIOR OF THE MARKET.

It would be innocent to assume that the old Tao philosophy has not influenced the Confucian thought. Physicists for some time looked at the alienation of Taoism with the contemporary thought of the physical world.

This suggest that in the actions of the Chinese managers there are, not only a pragmatism that aligns human actions with the process of adaptation within its environment, but that

<sup>8</sup> Li,2001:38.

<sup>9</sup> Malcom H. Cone & André M. Everett

there is an altruism that can be better understood using a framework provided by the evolutive psychology<sup>10</sup> identifying the cooperative behavior as an essential feature of survival in all living creatures, including human beings.

# Conclusions

## 5. Conclusions

- It is interesting to note that the behavior of work networks is another example of the complex behavior of business organizations in Chinese society.
- Cooperation based on mutual trust is the key for the organization's success.
- Cooperatives in China play a similar role to the western laws (survival of the fittest) while family ties play a similar role to western individualism. As a law, cooperatives serve as a force to ensure credibility in the market behavior.

<sup>10</sup> Heylighen, 1994



# DEVELOPMENT OF THE MICROFINANCE SYSTEM IN RUSSIA

Veniamin Kaganov

## 1. Development of Small Enterprises in Russia

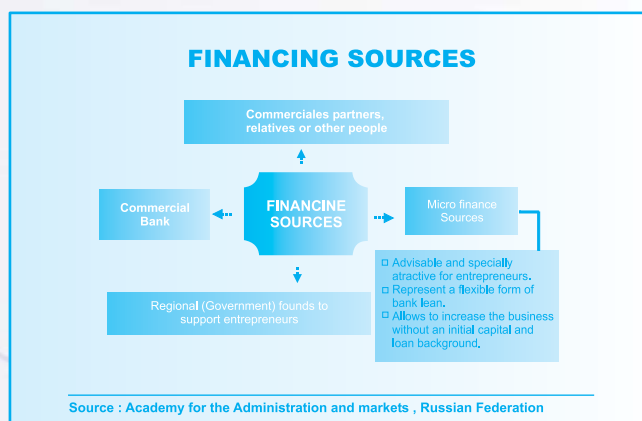
Eighteen years ago, there were no private business in Russia, there were only public businesses. Currently, there have been changes but it is necessary that time goes by to change the way of thinking of people. There are 5.6 million SMEs in Russia which includes 4.5 million of individual entrepreneurs, 90 percent of which are composed by established enterprises.

The majority of the SMEs start their operations with funds from commercial partners, relatives or other people due to the difficulty to obtain loans from the commercial banking. In Russia, two or three years ago, they started to give loans to micro enterprises; and it is a process that has developed in a very slow way and with certain difficulties.

The state administration has been more dedicated to social issues because there were other priorities. The micro finance institutions not only had the role of providing loans but also an additional challenge, to change the mentality of people. The work of micro finance institutions was centered and intensified to the furthest regions of Russia.

## 2. Micro Financing in Russia

The basic conditions of micro financing in Russia changed. Currently, the interest rate is between 4 and 6 percent in the first month and a reduction of the interest rate of up to 2 to 3 percent for a loan between US\$500 and US\$5000 and the repayment period is up to 3 months. The sources of financing in Russia are: commercial partners, commercial banking, regional funds and micro financing institutions. This can be observed in Figure N° 31.



Graph N° 31  
Financing Sources

The main objective of the micro financing is the creation of dynamic and efficient financial system for the SMEs, this promotes the use of financial services. The main tasks of the micro financial institutions can be observed in Table N° 7.

SMEs find some barriers to access loans through commercial banking due to the lack of warranties of micro businesspeople, and the lack of credit history; their loan requirements are for small amount of money (US\$500 - US\$5000). They have the need of a quick credit (few days - weeks), in addition they need other ways of support and additional advise to the borrowing itself, and from the side of the commercial banking, there are high levels of distrust towards micro enterprises.

### 3. Social Effect of Micro Financial Institutions (MFI's) in Russia

The MFI's create new job positions, especially in agriculture; they provide an opportunity for development of the economy of many people in different regions in Russia. The MFI's generally work with economically unprotected entrepreneurs in those regions, giving them the opportunity for economic development. It is important to highlight that more than 70 percent of the clients of the micro financing programs are women. In Table 8, the main characteristics of the microfinancing programs are shown.

The Micro financing system in Russia works at different levels through cooperative agriculture credits, commercial banking, group credits, government and micro financing institutions funds. One institution that promotes the micro credit is the Russian Center for Micro financing, this is a non-profit organization, and within the actions that it carries out are:

- It develops proposals for the improvement of legislation in the area of micro finance.
- It prepares the material for micro finance institutions.
- It offers advisory in the creation and development of new micro finance institutions.
- It develops regional and federal programs for the micro financial support, and
- It interacts with the Commercial Banking in specific micro finance topics.

MAIN TASKS OF MICROFINANCES	
Main Tasks of Microfinances	
-	To stimulate the efficient access to financial resources.
-	To create jobs.
-	To increase the tax revenues.
-	To create a credit record for the future development of MSEs through the financial sector.
-	To eliminate barriers so MSEs become formal.

Source : Academy for the Administration and markets , Russian Federation

Table N° 7  
Main Tasks of Microfinances

CHARACTERISTICS OF MICROFINANCING PROGRAMS	
Characteristics of Microfinances Programs Summary	
<input type="checkbox"/>	Monthly average of interest of micro loans - 4 %.
<input type="checkbox"/>	Average amount of lending - \$ 800 USD.
<input type="checkbox"/>	Average loan per customer - \$ 1500 USD.
<input type="checkbox"/>	Loan Distribution.
<input type="checkbox"/>	Trade - 55%.
<input type="checkbox"/>	Personal services payment - 24 %.
<input type="checkbox"/>	Agriculture - 11 %.
<input type="checkbox"/>	63 % of the loans are granted to the businessmen beginners.
<input type="checkbox"/>	The demand for loans for microenterprises is around \$ 4.5 trillions of USD.
<input type="checkbox"/>	Number of MFIs in Russia. Approximately 300.

Source : Academy for the Administration and markets , Russian Federation

Table N° 8  
Characteristics of the Microfinancing Programs

MICROFINANCING SYSTEMS IN RUSSIA	
Microfinancing Systems in Russia	
<input type="checkbox"/>	Agriculture / Cooperative loan
<input type="checkbox"/>	Group loans
<input type="checkbox"/>	Commercial banking.
<input type="checkbox"/>	Microfinance institutions
<input type="checkbox"/>	Government funds (regional funds) support to the small enterprises.

Source : Academy for the Administration and markets , Russian Federation

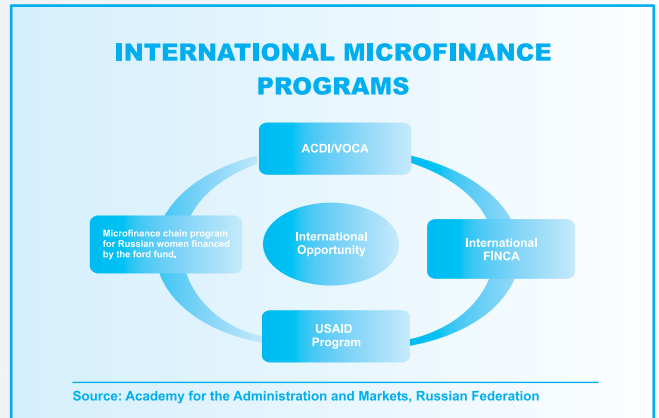
Table N° 9  
Microfinancing Systems in Russia

The origin of the micro finance system of Russia is found in the international programs, and the international experience has been satisfactorily used. In Graph N° 34, the International Micro Finance Programs are identified.

#### 4. Achievements in the Micro Loans Areas in 2002-2004

Among the achievements and progress of micro credit in the years 2002-2004 are the following:

- Banks increased the volume of financing to small enterprises.
- They started to use percentages of flexible interest.
- The simplification of the approval procedures of loan applications and loan collocations was carried out.



Graph N° 32  
International Microfinance Programs

In this context and in the permanent search of favorable conditions for micro finance institutions, the need to improve the legal framework was identified. Federal laws of credit and cooperation have been developed and adopted in the Federal Republic. An amendment to the Law of Consumer Cooperatives is being carried out, oriented to the provision and sustainable development of such cooperatives. The Mozoroff project has as a main objective the promotion of SMEs, through different mechanisms such as the support for Start ups, training, and promotion of association. In Table N° 10, the objectives and organizational structures in which this project is supported are detailed.

Table N° 10  
The Morozoff Project

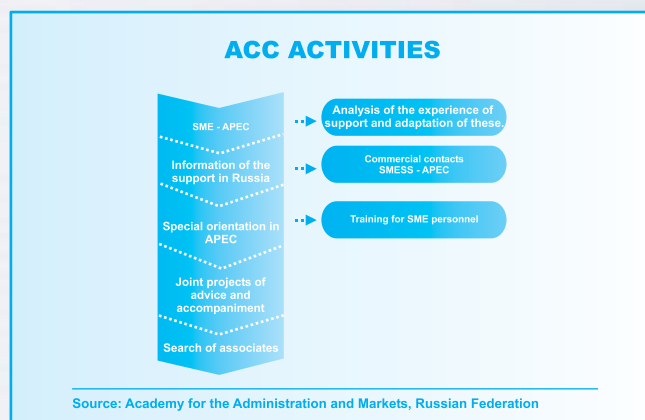
THE MOROZOFF PROJECT	
Objectives	Structure
<input checked="" type="checkbox"/> To support the enterprise start up.	<input checked="" type="checkbox"/> Academy for the Administration and Executive Market Management.
<input checked="" type="checkbox"/> To prepare personnel for the small enterprise.	<input checked="" type="checkbox"/> Centers of Regional Business Training.
<input checked="" type="checkbox"/> To support the request for innovations.	<input checked="" type="checkbox"/> National association for Businesses Incubation.
<input checked="" type="checkbox"/> To help in the development of the enterprise's partners	<input checked="" type="checkbox"/> National agency to support the entrepreneurship "INTECH"
<input checked="" type="checkbox"/> To develop territories using the potencial of entrepreneurs	<input checked="" type="checkbox"/> Microfinancing Centers.

## 5. New Projects

The APEC Center of Cooperation (ACC) of Russia was founded in 2002, whose objective is to seek new channels to get in the international network of enterprises. The activities that it carries out are as follows:

- It proposes to facilitate the development of Russian businesses through the promotion and international cooperation in the APEC regions.
- It creates cooperative networks within the incubators enterprises in Russia.

The main activities of the ACC are shown in Graph N° 33:



Graph N° 33  
ACC Activities

# Conclusions

## 6. Conclusions

- The main objective of microfinance institutions are the creation of a dynamic and efficient financing system for the micro and small enterprises, which should promote the use of microfinance services.
- Microfinance Institutions (MFI) should generally work with economically unprotected entrepreneurs, trying to reduce the barrier of access to credit like lack of guarantees, lack of credit history, loan requirements for very small sums, among others.

# BUSINESS CASE STUDY

## «KOLA REAL»

Alfredo Paredes ●

### 1. Background of AJEGROUP.

Ajegroup is a Peruvian multinational business in constant growth that is dedicated to the production of sodas. Throughout Latin America, the main brand of the group is Kola Real and Big Cola.

Ajegroup is a business with a great experience and entrepreneurial culture that distinguishes it. One of the main characteristics is that it possesses the capacity to act and compete in adverse conditions and the courage to decide and face challenges. It initiated its operations in the conflicting Ayacucho during the most complicated era of the Peruvian terrorism.

This enterprise has a very well defined strategy and focus with a clear objective of democratize the consumption of sodas. This has allowed the group to currently find itself in a leader position.

Next, a summary table with the history of the enterprise and its main critical factors is shown.

### 2. Success Critical Factors.

AJEGROUP considers the following critical factors in its business development.

- Development of its own brand, saving in franchise payment.
- Strategy oriented to people or consumers where saving is paramount (fair price)
- Less investment in advertising and more product value.
- Light structure and administrative spending.
- Own / self distribution and horizontal coverage.

Table N° 11  
History and Critical Factors of Success of AJEGROUP

History	Critical Success factors
The enterprise starts its operations in the city of Ayacucho in 1988, place where terrorism began in Peru.	
The business was founded with 15 employees	
The challenge of small scale production and commercialization is started. The enterprise starts its operations in Lima (the capital of Peru) in 1997.	
It starts its internationalization process in 1997.	
Currently, AJEGROUP has 8 production plants (Huachipa, Sullana, Tarapoto, Uquitos, Pucallpa, Trujillo, Ayacucho and Huancayo).	
The installed capacity of Ajegroup is 250 million annual liters.	The critical factors are:
Currently, the brands that it offers consumers are: <ul style="list-style-type: none"> <li>• Agua Cielo</li> <li>• Kola Real (flag brand in Peru)</li> <li>• Big Cola (regional brand)</li> <li>• First (grapefruit flavor brand)</li> <li>• Sabor de Oro</li> <li>• Spore (rehydration drink)</li> <li>• Pulp (nectars)</li> </ul>	<ul style="list-style-type: none"> <li>• Development of own brand which allows saving on franchise payment.</li> <li>• Strategy oriented to people or consumers for which saving is more important (fair price).</li> <li>• Less investment in publicity and more product value.</li> <li>• Light structure and administrative expenses.</li> <li>• Own distribution and horizontal coverage</li> </ul>
It has 24 distribution centers.	
It maintains a 19% of the Peruvian Market share (liters).	
Currently, it has operations in Ecuador, Venezuela, Mexico, Guatemala and Honduras.	
It generates 7500 direct and indirect job positions.	
It carries out social responsibility actions with the community, working with health clubs and offering support to universities in Ayacucho, among others.	
The Eduardo and Mirtha Añanos (Ajegroup founders) Foundation is created to work on different entrepreneurship programs with youth and MSEs in Peru.	

Source : Presentation AJEGROUP

### 3. The Benefits of Being Formal

Kola Real started its operations in 1998 in Ayacucho. At that time, terrorism forced the family to move from the fields to the city. In such difficult times, few people started new enterprises. In that business climate, Mr. Eduardo Añanos and his eldest son embarked in an adventure by putting a small factory together. During the first two years, the company develops by selling soft drinks in beer bottles. As it starts to grow, they extended their area of influence. In 1996, beer companies did not allow them to continue using their bottles so they had to create their own bottles.

Formalization allowed this enterprise to grow; first, in provinces and then in Lima. Today AJEGROUP has expanded its operations in Latin America consolidating in Mexico. Also in 2006 it has opened a plant in Thailand. The group is expanding operations and will venture in the beer market.

The organization's strengths are:

- Quick decisions.
- Creativity.

- Anticipate facts.
- Courteous manners.
- Action: you have to act; do things.
- Continuous improvements.
- Cost-Benefit Analysis: Evaluation

# Conclusions

## 4. Conclusions

- The characteristics of an entrepreneurial culture makes it possible for companies in adverse conditions to emerge, AJEGROUP is an example.
- Keeping a strategy and a defined approach on management allows success of AJEGROUP. Its main objective of democratizing soft drinks consumption has been a pillar in its current leading position.



# BUSINESS CASE STUDY «GRUPO ROCIO»

Rafael Quevedo

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## 1. Background of Grupo Rocio

Grupo Rocio is a Peruvian business dedicated to the agricultural and agroindustrial in the national and international environment. The activities developed by this firm have been located in the northern Peruvian desert. With approximately 40 years of experience and hard work, this enterprise has achieved to make the agricultural and agro export sector of the Peruvian economy more dynamic. In the next page, the history and the Critical Factors of Success of Grupo Rocio are shown.

This enterprise provides several lessons of importance in the agricultural and agroindustrial sectors for the development of these activities. One of them is to establish a strategic alliance between universities, private businesses and state research centers, so that together an adaptive research is developed according to the characteristics and potential of every ecologic niche.

The outcomes of these researches, through an efficient rural education system, should be translated to small and medium producers, to improve their productivity, insert them in productive chains, and thus elevate their living standards.

Another great lesson learned by this important economic group is the need to have access to markets. Without this, it is impossible to develop agroindustry. Before investing in the agriculture, it is of vital importance to carry out market studies.





Table N° 12  
History and Critical Factors of Success of Rocio Group

History	Critical Success Factors
The enterprise starts its activities in 1967 with the small scale development of the poultry activity in the desert lands located in the District of Viru, La Libertad, northern region of Peru.	Developing an efficient staff
The group has fought to turn the desert into productive land in the shortest time, trying to overcome obstacles during the different economic and political experiences that Peru has faced in the last 40 years.	Constant training
The poultry activity is seen as an engine that prompts agriculture activities.	Innovation
The products offered by Grupo Rocio are: <ul style="list-style-type: none"> <li>• Asparagus</li> <li>• Peppercash</li> <li>• Sweet potato</li> <li>• Bovine meat</li> <li>• Bovine skins</li> </ul>	Constant research
Currently, it generates 2400 permanent job positions. It contributes to the Public Treasury more than nine million soles in taxes.	Efficient use of water resources
It offers support to universities, contributing with professors that provide courses such as irrigation, agriculture entomology, etc. Also, it carries out research and internships in Grupo Rocio's fields.	High Tier Technology use.
The group participates in national and regional events, in which it shares experiences with producers and students of different disciplines.	Earnings reinvestment
The group has participation in regional productive chains with corn producers, assuring a market for its products and providing technical advisory to achieve a profitable production.	Environmental concerns and biological control

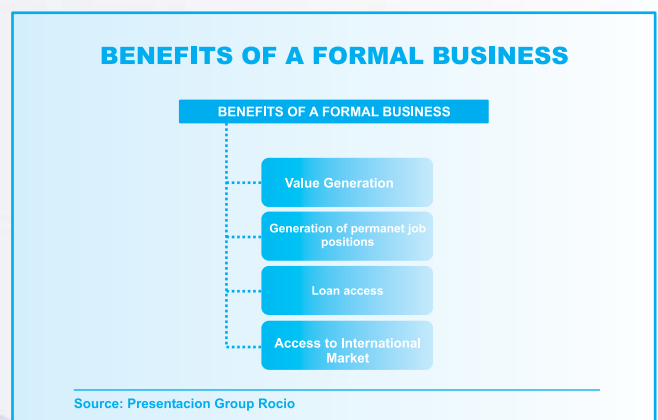
Source: Rocio Group Presentation

The foreign purchasing companies have started to ask that the products that they acquire be produced in an ecologically-friendly environment, which is achieved through the application of good management practices not only in the factories but also in the field. This will help keep an ecologically sustainable system.

**EFFICIENCY HAS STOPPED BEING A COMPETITIVE ADVANTAGE TO TRANSFORM INTO A REQUIREMENT TO BE ABLE TO SURVIVE IN AGRICULTURE**

## 2. Benefits of Being Formal

The benefits of being a formal business are the generation of value, the generation of stable job positions, the access of financing, and the international market. This is the perspective rendered by the Rocio Group, as shown in Graph N° 34.



Graph N° 34  
Benefits of a Formal Business

# Conclusions

## 4. Conclusions

- Rural development depends much more in the adequate training of farmers than in the abundance of resources, much more of intellectual inputs than of the material inputs.
- A large portion of the farmers' problems may be solved by themselves with the condition that they received a technical-entrepreneurial training oriented to produce economic results and not only in carrying out activities. This means training more committed in solving problems than in formulating solutions.
- The productive diversification and the step-by-step introduction of innovations (advance from less to more, start in small scale, start from the micro to the macro, and from the possibility to reach the desirable) are strategies so that the very poor farmers also have real opportunities of becoming more efficient and productive.
- The more realistic solution to the problems in agriculture in Latin America is technological and managerial efficiency of farmers and the entrepreneurial-organization strength of its communities.

## **PANEL III:**

### **FINANCIAL SERVICES AS A TOOL FOR THE DEVELOPMENT OF MSES**

- Theme:** **LOAN PROCESSING OF THE SMALL BUSINESS ADMINISTRATION OF THE UNITED STATES**  
Mr. Sloan Coleman, Specialist in Regulation of the Office of Financial Assistance in the Small Business Administration of the United States.
- Theme:** **PROGRAMS FOR SMES AND MICROFINANCE OF THE ANDEAN CORPORATION OF PROMOTION**  
Mr. Manuel Malaret, Direction of SME and Micro finance of the Andean Corporation of Promotion.
- Theme:** **FINANCIAL SERVICES: A DEVELOPMENT TOOL FOR THE MICRO AND SMALL ENTERPRISES IN PERU**  
Eng. Jose Zapata, Superintendence of Banking and Insurances (SBS) of Peru.
- Theme:** **SEED CAPITAL LOAN FOR MICRO ENTERPRISES IN CHINESE TAIPEI**  
Mrs. Li-Li Shih, Specialist in Financing of the Small and Medium Business Administration of the Ministry of Economic Affairs of Chinese Taipei.
- Theme:** **CURRENT SITUATION OF MICROFINANCE INSTITUTIONS IN KOREA**  
Mr. Hong-Kee Kim, Professor of the Department of International Trade of Hannam University, Korea.
- Theme:** **GUARANTEE MECHANISMS TO FACILITATE LOAN ACCESS TO MSES IN PERU**  
Mr. Edgard Coquis Fernandez-Davila, General Manager of the Guaranty Fund Foundation for loans to the Small Industry (FOGAPI)

# LOAN PROCESSING OF THE SMALL BUSINESS ADMINISTRATION OF THE UNITED STATES

Sloan Coleman

The Small Business Administration (SBA) has 54 years of experience and has been working hard during that period in order to mainstream the informal sector.

First, the SBA was granting loans from the treasury funds directly to people who did not apply to the financial system. Also, the SBA reviewed the background of the loan with the bank which generated duplicity in the revision.

At the beginning, employees of different SBA agencies came from the Federal Government; that is, from the formal sector, which generated the need of a proper training to achieve understanding of the informal sector.

The SBA with time has modified these practices because it was more economic and more efficient in providing funds. The SBA no longer provides loans directly to entrepreneurs. Regarding the review of credit history, this function has been left to banks, something that has meant optimizing processes (in terms of time) of the transaction, being the bank the only one with the authority to carry these actions. In the long run, this has resulted in the lack of loan analysis, and given that most of the SBA team is close to retirement, this causes a close dependence to the bank in loan reviews.

For the success of micro loan allocation on behalf of SBA, it has been necessary to offer personnel training. This training has been focused mainly in financial assistance, business operation and nature of the loan.

The SBA has the following programs:

- SBA Micro loans program
- Regular loans program (Program 7A)
- Guarantee System

The guarantee program does not require many resources and generates an income (fee) for these transactions. There is no minimum amount of guarantee but, it instead establishes (not by law) an amount of \$7 500 mainly due to the transaction costs of the guarantee. In the last 10 years, 14 percent of all guaranteed loans have failed in fulfilling the payments.

SMALL ENTERPRISE FINANCING MUST BE PART OF ANY ECONOMY'S STRATEGY FOR ECONOMIC GROWTH. THE SITUATION OF SMALL ENTERPRISES IS A GREAT INDICATOR OF THE ECONOMY IS DOING.

When this occurs, the guarantee fund activates.

SBA used to guarantee up to 90 percent of the loan. This measure was given as way to interest financial institutions in increasing their loans; however, in practice SBA observed that financial institutions were not doing the appropriate follow-up to guaranteed loans compared to non-guaranteed ones. This forced to enforce the following measures:

- I. Reducing the guarantee to 75 percent of the loan,
- II. Establishing a defined guarantee structure,
- III. Guaranteeing the loan against the goods acquired with the loans
- IV. Conditioning the guarantee execution to certain pre-established contract conditions.

The mechanisms used to increase the number of loans have been:

- The creation of a secondary market.
- The creation of regulatory agents like the Federal Reserve.

The secondary market is where borrowers transact with lenders (or investors) the portion guaranteed by the SBA, the same that becomes an unconditional guaranty for the investor but a conditional one for the lender.

The Federal Reserve monitors the use of depositor's money and makes public reports called «notebook» of the financial entities about the adequate use of their funds. That allows tracing along funds placed in the community. In the seventies, the Federal Reserve decided to make these notebooks public. This allowed the public to watch the direction of the placed loans and to identify commercial groups, economic segments, ethnic groups and geographic segments that were favored. The notebook mechanism assigns additional points to banks that allotted loans in less favored segments. This fosters loans in small enterprises achieving dynamism in this market.

The program takes place through micro-financing institutions, which are in charge of placing funds in micro and small enterprises. These institutions give their clients up to 6 years to pay their loans and the SBA gives them in return up to 8 years to pay these funds.

The SBA grants funds to micro finance institutions ranging from \$500,000 to \$1'000,000 as a fund without payments during the first year. If the institution keeps a portfolio of micro-loans below \$15,000 it is called a «magic number». In that case, the SBA allows to decrease the charged fee and to increase the interest rate charged to the lenders. This rate is usually around 10 percent or 11 percent and works as an incentive for the micro-lenders.

Regarding micro loans, the main problem of the SBA is finding micro finance institutions that understood the meaning of micro loans and that made the appropriate loan evaluation and analysis of the creditors' business plan.

Another program managed by the SBA is the regular loans program, known as 7A that refers to the legislation that originates section 7A that the SBA established. The use of proceeds may be to purchase real estate, machinery and equipment and for working capital. The longest term is 25 years for real estate, 5 to 7 years for working capital and in the case of machinery and equipment it will depend on the useful life of the assets. Therefore, the maturity of the guarantee is based on the use of proceeds and on the repayment capacity of

the company.

Another service that the SBA provides is the Guarantee System. There are two main reasons why a borrower would require a guarantee from the SBA:

- The bank demands an SBA guarantee for a long term of payment.
- The creation of new businesses.

Around 33 percent of the SBA business is the creation of new businesses because normally, financing entities are not willing to take that risk.

# Conclusions

## 1. Conclusions

- The mechanisms of the secondary market and «notebook» promote Microfinance Institutions' development.
- The adequate risk analysis of loans through business plan analysis is a critical success factor in fund placing of microfinance institutions.
- The guarantee system to create new businesses promotes entrepreneurship in the population



# PROGRAMS FOR SMES AND MICRO FINANCE OF THE ANDEAN CORPORATION OF PROMOTION

Manuel Malaret

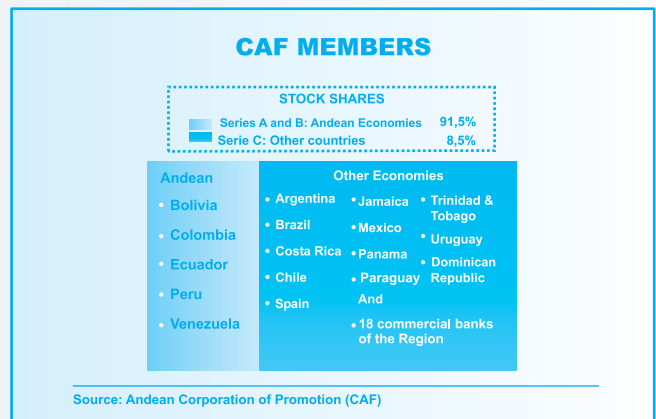
## 1. Andean Corporation of Promotion (CAF)

CAF mission is centered in promoting sustainable development and regional integration through an efficient mobilization of resources. The purpose is to render timely and multiple financial services of high added value to private and public clients from stockholders economies. The distribution of CAF stockholder property is shown in chart N° 35.

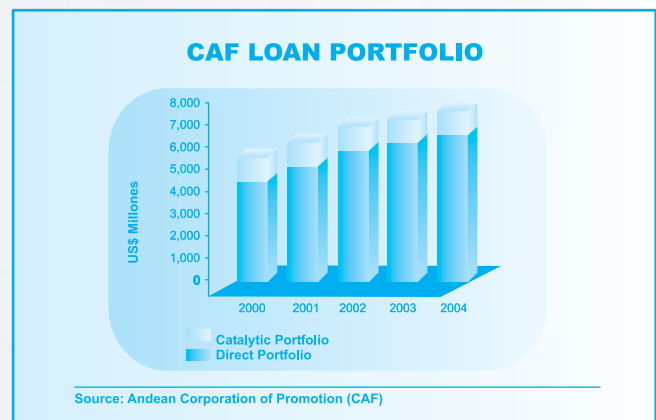
CAF is a competitive financial institution, customer-oriented, sensitive to social needs and supported by a highly specialized staff.

Investment and credit portfolio has grown in 2004, reaching \$7,200 million approximately. Its evolution during the years 2000-2004 is shown in Graph N° 36.

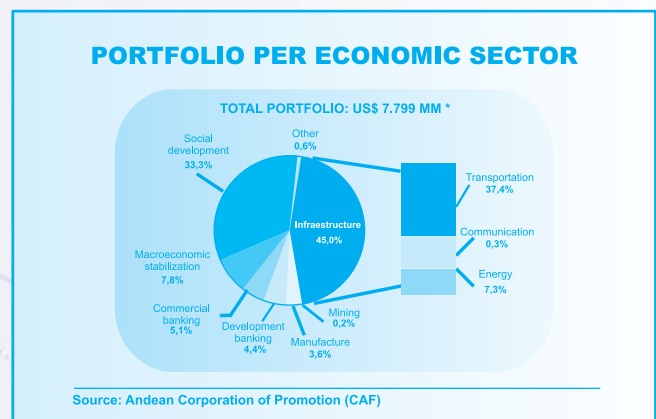
The portfolio composition by economic sector shows that 45 percent goes to infrastructure that is transportation, communications and energy. There is also an important section of social development including education, health and sanitation which is about 33 percent of total portfolio. Finally, a 5.1 percent of the portfolio goes to commercial banking and 4.4 percent to development banking. A large amount of these resources ends up in the hands of small and medium sized enterprises through financial intermediaries.



Graph N° 35  
CAF Members



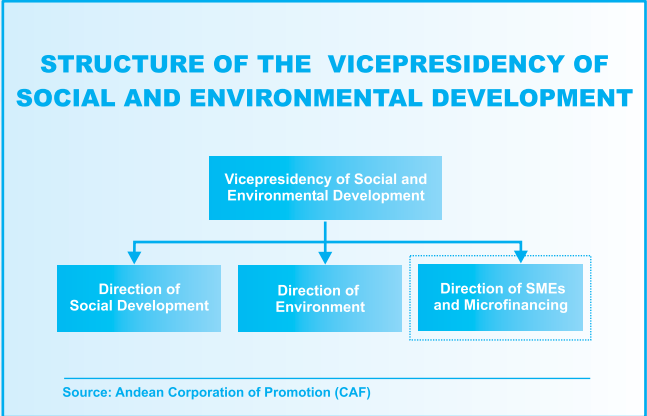
Graph N° 36  
Portfolio per Credits CAF



Graph N° 37  
Portfolio by Economic Sector

## 2. The Vicepresidency of Environmental and Social Development

The Vicepresidency of Environmental and Social Development has the mission to support business initiatives that include social and environmental benefits with an approach of innovation, replication, sustainability and territoriality. Under the Vicepresidency, there is a Direction of Social Development, a Direction of Environment and a Direction of SMEs and Micro finances.



Graph N° 38  
Structure of the Vicepresidency of Social and Environmental Development

The Direction of Social Development is in charge of granting credits to central governments and municipalities for projects in education, sanitation and health. The Direction of Environment makes sure that corporation projects comply with environmental and national rules demanded by the institution.

## 3. Direction of SMEs and Micro Finances

The Direction of SMEs and Micro finances is a new direction with only one year and four months of constitution. The mission of this direction is to promote business initiatives in sector with limitations on access to financing. This is oriented mainly for micro-enterprises, small businesses and rural sector which are all poorly serviced by traditional banking.

**CAF'S STRATEGY**

CAF Strategy		
Access to Capital	Internacionalization	Insertion
It implements financing mechanisms for the MSMEs. It supports private sector in projects with social benefit and financial efficiency.	The creations and execution of export support programs are promoted.	It fosters the inclusion of SMEs in CAF projects.

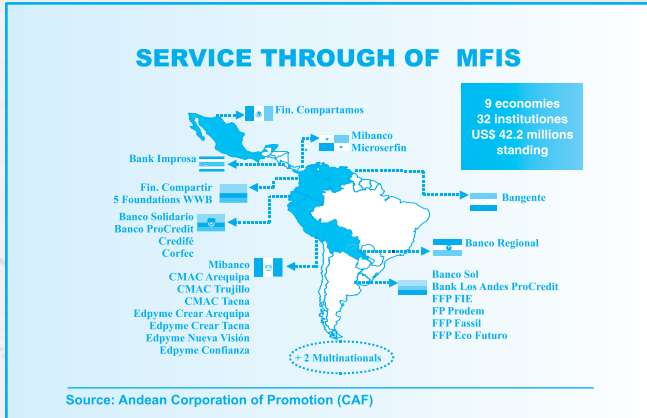
Source: Andean Corporation of Promotion (CAF)

Table N° 13  
CAF'S Strategy

In Table N° 13 shows the strategy of CAF related to access to capital, internationalization and insertion of SMEs in CAF projects.

The micro-financing activity reaches people through micro-financing institutions located in nine economies. There are 32 institutions attending 1.4 millions of micro-entrepreneurs. These micro-financing institutions are regulated by banking supervisors (superintendence's) of the correspondent economies. It is expected to reach non-regulated institutions whenever more efficient mechanisms are achieved.

It is intended to extend the scope of action to more families and other sectors like health, education and agriculture, and in all stockholders economies. To achieve this, development of new products and financial services will be supported. At the present, the major activity is concentrated on urban areas, but rural micro-financing will be promoted in the short run. The presence of CAF through MFIs (Micro-Financing Institutions) in South America, North America and Central America is shown in Graph N° 39.



Graph N° 39  
Service through of MFIs



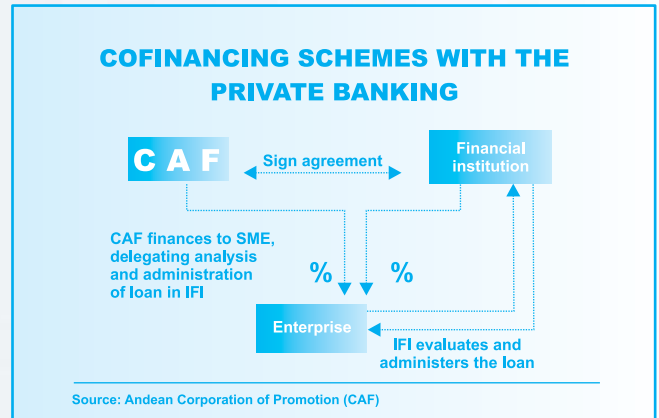
The mechanisms to reach SMEs are the following:

- Scheme of co-financing with private banks
- Articulation with high social impacts mechanism
- National and regional guarantee fund.

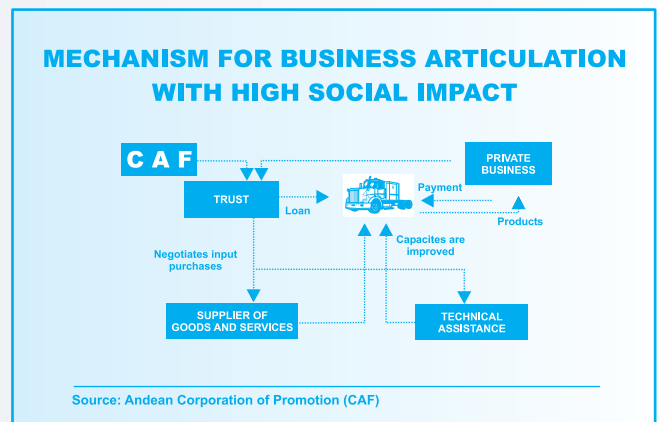
Banks with good penetration and knowledge of SMEs should be identified in order to sign cofinancing agreements. The bank chooses, administrates and analyses the loan and the CAF lends funds in the same proportion as the bank, sharing risks in a very direct manner. This structure is shown in chart N° 40.

Another important mechanism is the articulation with high social impact. An example of this is an agroindustrial enterprise in Ecuador that wanted to help managers of the same sector with technical and management assistance. With support of CAF, the enterprise created a trust fund that provides financing to entrepreneurs through a loan program.

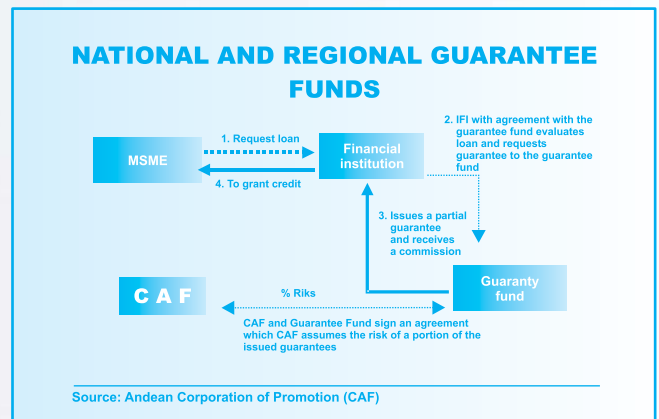
National and regional guaranty funds work by signing an agreement between the Corporation and the guarantee fund by which CAF absorbs part of the risks of a portion of the issued guarantees. The guarantee fund through financial institutions grants loans MSMEs. These funds have been invested in Trinidad & Tobago, Venezuela and Ecuador



Graph N° 40  
Cofinancing Schemes with the Private Banking



Graph N° 41  
Mechanism for Business Articulation with High Social Impact



Graph N° 42  
National and Regional Guarantee Funds

# Conclusions

## 4. Conclusions

- CAF's strategy regarding SME and Microfinancing Institutions is centered in three pillars. These are access to capital, internationalization and SME insertion in CAF projects.
- The mechanisms used by CAF to develop Microfinancing Institutions are: Cofinancing with private banking institutions, high social impact articulation and, national and regional guarantee funds



# FINANCIAL SERVICES: A DEVELOPMENT TOOL FOR MICRO AND SMALL ENTERPRISES IN PERU

José Zapata

## 1. The Peruvian Financial System

### 1.1. Financial Intermediaries That Offer Services to MSEs

There are two types of financial intermediaries in Peru: regulated entities and non-regulated entities.

- **Regulated entities:** Include all institutions supervised by the Superintendencia de Banca y Seguros (in Spanish, Superintendencia de Banca y Seguros- SBS). However, there is a group of entities that are not regulated by the Superintendencia but that are supervised by other organizations such as Saving and Loan Cooperatives.
- **Non-regulated entities:** These are non-governmental organizations or non-profit associations dedicated to financial activities

The structure of the Peruvian financial system is 92 percent of commercial banking and only 6.7 percent of micro-financing institutions, as shown in table N° 14.

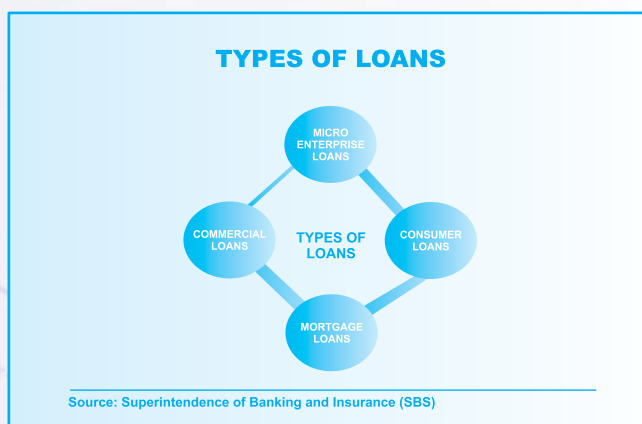
### 1.2. Types of Loans

SBS defines that there are four types of loans: consumer loans, mortgage loans, commercial loans and micro enterprise loans.

Composition of the Peruvian Financial System			
March 2005	N° of Enterprises	Amount mill US\$	%
Multiple banking	13	19,745	91.7 %
Financial businesses	4	335	1.6 %
Microfinance Institutions	41	1,447	6.7 %
Banking	1	176	0.8 %
Municipal saving	14	943	4.4 %
Rural saving	12	184	0.9 %
EDPyMEs	14	144	0.7 %
Total	58	21,527	100 %

Source: Superintendencia of Banking and Insurance (SBS)

Table N° 14  
Peruvian Financial System



Graph N° 43  
Types of Loans

## 2. Regulatory Framework For Financial Institutions

### 2.1 Regulation For Micro-Finance Institutions

The regulation for Micro Finance Institutions is based on the General Law N° 26072. Micro-finance institutions and their operations are regulated with the same rules as banking institutions. The only difference is the minimum requirement of capital and the number of allowed operations, taking into account inherent risks in the activities they carry out.

Between April and June 2000, the minimum social capital established by law for the entry of new micro-financing enterprises (CMACs, CRACs and EDPYME) was \$276,000. In contrast, the minimum for a banking entity was \$6'000,000.

### 2.2 MFI Operations

The common operations of non-banking MFIs include direct loans with or without guaranty, written guaranties and letters of indemnity and carry out collections, payments and fund transfers to their own offices and/or bank correspondents. Likewise, operating in foreign currency is allowed.

There are, however, some differences by law. Whereas the CMACs and the CRACs are authorized to obtain savings and long term deposits, the EDPYMEs in the beginning are not allowed to collect deposits from the public.

### 2.3 Modular Operations Scheme

The current legislation contemplates the possibility that MFIs extend the range of their operations under a modular scheme depending on their increase of their levels of capital and when having risks qualification, a greater level of organization and proper internal control.

Law N° 28393 has established that those enterprises that are object of fusions, absorptions or increases in capital will be able to access new operations under an special authorization without doing all the operations of a module. This will allow to increase the number of operations offered by non-banking micro-financing institutions. Therefore, this will translate in offering a better service to micro-borrowers.

## 3. Structure of Micro Finance System in Peru

The structure of the Micro Finance System in Peru is composed by banks (Mi Banco), CMACs, CRACs and EDPYMEs. By March 2005, there were 41 institutions that represent 8.9 percent of the loans placed by the financial system. In table N° 15 the assets, deposits, equity and other indicators of the micro-finance system in Peru are displayed.

STRUCTURE OF MICROFINANCE SYSTEM IN PERU						
Structure of Microfinance System in Peru						
March 2005	MI Banco	Millones de US\$				% Fin. Sys
		CMACs	CRACs	EDPYMEs	Total IMF's	
Number of Institutions	1	14	12	14	41	69.50 %
Assets	176	943	164	144	1,447	6.70 %
Placements / Allocations	138	699	138	122	1,097	8.90 %
Deposits	96	564	114	0	774	6.70 %
Equity	34	157	23	47	261	11.70 %
Leverage (N° of times)	5.09	5.74	6.37	2.9		
N° Debtors	121,79	566,815	84,022	122,323	894,95	33.60 %
N° Savings	40,125	632,328	161,200	0	834,153	11.60 %

Source: Superintendence of Banking and Insurance (SBS)

Table N° 15  
Structure of Microfinance System in Peru

Graph N° 44 shows the average growth of micro-finance institutions versus the commercial banking between 2001 and 2005. The number of debtors in MFIs has increased from 330,000 to 895,000 in this period. Likewise, the average balance of loans has exceeded \$1,200 in march 2005.

Regarding the concentration of loans from banks and financing institutions, in Lima it reaches 97.3 percent of their total loans, unlike micro-finance institutions with only 2.7 percent. In the provinces, it is not so different since 70.9 percent of total loans are from banks and finance institutions while MFIs account only for a 29.1 percent, as shown in table N° 16.

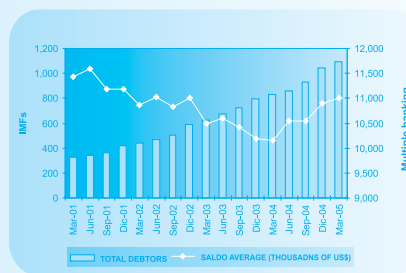
#### 4. Micro Enterprises Loans

Total balance of loans to MSE sector accounts for \$1.14 millions, representing 7 percent of total loans in the financial system. It is a small number but compared to 2001 there has been a growth (of over 5 percent) in these years, since that percentage was only of 2 percent. The distribution of MEs credit in this sector by type of institution is shown in table N° 17.

This credit is classified according to the Uniform Industrial International Code (CIIU). The major participation comes from wholesale and retail commerce with a 43.5 percent, followed by 14.1 percent of common services, as shown in table N° 18.

There is a tendency to segment the MSE sector which is attractive for commercial banking because there are more developed clients in these niches. These clients are becoming eligible for larger loans with better rates. Due to this, the trend is that micro finance institutions are discovering new market segments. As shown in chart N° 45, there is a trend of progressive reduction of interest rates in the period of analysis (December 2002 - March 2005).

### AVERAGE GROWTH OF IMFS VERSUS BANKING COMMERCIAL BETWEEN 2001 AND 2005



Source: Superintendencia de Banking and Insurance (SBS)

Graph N° 44  
Average Growth of IMFs versus Commercial Banking Between 2001 and 2005

### RELATIVE CONCENTRATIONS OF LOANS AND DEPOSITS IN LIMA AND PROVINCES

Relative Concentration Lima y Provinces		
Loans		
	Banks and Finance Institutions	Total IMFs
Lima	97.3%	2.7%
Province	70.9%	291%
Deposits		
	Banks and Finance Institutions	Total IMFs
Lima	98.4%	1.6%
Province	77.6%	22.4%

Source: Superintendencia de Banking and Insurance (SBS)

Table N° 16  
Relative Concentration of Loans and Deposits in Lima and Provinces

### MES LOAN DISTRIBUTION (MILLIONS OF US\$)

Distribution of credits MES					
Placements	MES	Value	N° Debtors	MES	
Entities	Saldo	%	March 04	March 05	%
Municipal Saving	353	34.90%	26,50%	260,694	38,98%
Bank of Credit	174	17.20%	22,10%	53,363	7,98%
Other Banks	118	11,60%	38,90%	36,223	5,42%
Mi banco	118	11,60%	27,80%	83,539	12,49%
EDPYMEs	94	9,30%	17,90%	83,408	12,47%
Rural Saving	90	8,90%	32,80%	107,211	16,03%
Other	67	6,60%	32,90%	44,371	6,63%
Total	1,014	100,00%	28,00%	668,809	100,00%

Source: Superintendencia de Banking and Insurance (SBS)

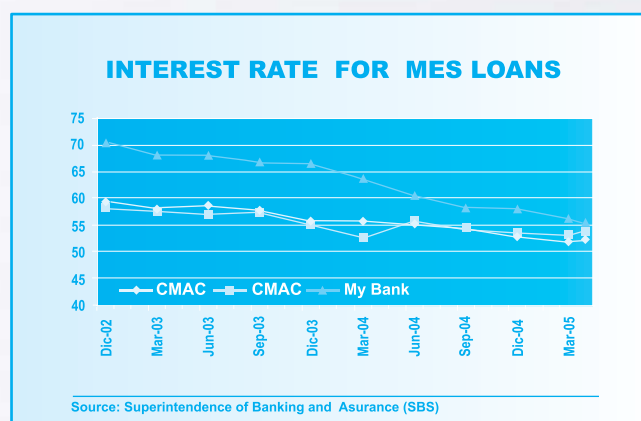
Table N° 17  
Distribution of Credits MEs (millions of US\$)

### DISTRIBUTION BY ECONOMIC ACTIVITY

Distribution by Economic Activity	
Category	Part. %
Wholesale and retail trade	43,5%
Other service activities	14,1%
Manufacturing industries	8,8%
Real state, business hunting storage and commercialization activities	8,3%
Agriculture, stockbreeding, hunting and silviculture	7,2%
Transportation, storage and communications	5,8%
Other activities	12,4%
Total	100,00%

Source: Superintendencia de Banking and Insurance (SBS)

Table N° 18  
Distribution by Economic Activity



Graph N° 45  
Interest Rate for MES Loans

# Conclusions

## 5. Conclusions

- The micro finance market is becoming more competitive. Commercial Banking is more interested in penetrating these segments attracted by high profit margins.
- There is an ample market waiting to be serviced by the finance system given the need for loans by MSEs, which constitutes one of the most dynamic sectors and with great financial needs.
- The micro-finances market has become more and more competitive and this competition must promote a greater reduction on interest rates. However, given the characteristics of micro loans, the interest rates will not be the same level as those offered to corporate customers or commercial banking customers.
- Financial institutions offer diverse financial services to the MSEs, although emphasis remains on the loan side. Facing this increasing competition, financial institutions will have to improve the quality and the cost of the services they offer in order to maintain and/or increase their market share. Greater innovation in financial services available to MSEs are expected in the coming years, including diverse modalities of liability products, insurances, fund transfers, among others.

# SEED CAPITAL LOAN FOR MICRO ENTERPRISES IN CHINESE TAIPEI

Li- Li Shih.

## 1. How to define Micro Enterprise in Chinese Taipei?

The definition of micro enterprise in Chinese Taipei is established by two criteria: sales amount and number of workers. A micro enterprise is an organization registered according to Law with less than 5 employees. A small and medium enterprise in the manufacturing sector keeps incomes below 80 millions of NDT dollars or has less than 200 workers. In the services sector, the incomes should be less than 100 millions of NDT dollars and less than 50 employees.

## 2. Why Promote Start Up Loans?

The main purpose is to encourage middle-aged and unemployed people to start up their own business, which will help rebuilding the entrepreneurial spirit. The distribution of domestic enterprises has four levels:

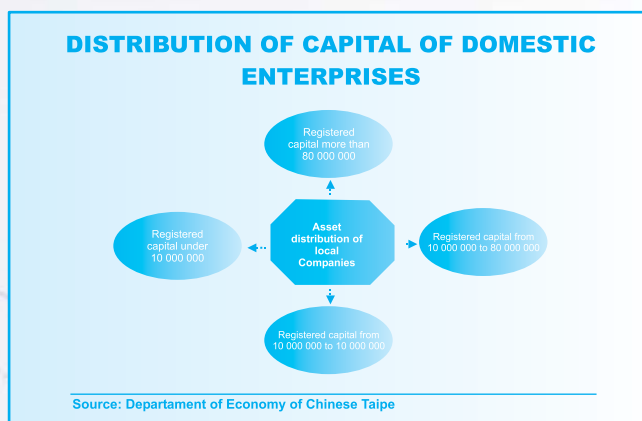
- i) Those with more than \$NDT<sup>1</sup> 80 million of registered capital are called large enterprises.
- ii) Those with capital between \$NDT 10 million and \$NDT 80 million.
- iii) Enterprises with \$NDT 1 million up to \$NDT 10 million of registered capital.
- iv) Finally, there are enterprises with capital under \$NDT 1 million.

There are about 1'171,780 domestic enterprises, where large enterprises account for about 2.17 percent and small and medium enterprises account for 97.83 percent. There are about 600,000 small and medium enterprises that registered capital under \$NDT 1 million.

## 3. How Do Start Up Loans Work?

The source for start up loans of local financing institutions is these institutions own reserves. This means that government does not finance them.

In table N° 19 the characteristics of start up loans are explained.



Graph N° 46  
Asset Distribution of National Business

Table N° 19  
Characteristics of the Start up Loans

Qualification and Limitations	Considerations for Loan applications	Loan Characteristics	Guarantee and guarantor
<p><b>QUALIFICATION</b></p> <p>Individual from 45 to 65 years old that qualify one of the following conditions:</p> <ol style="list-style-type: none"> <li>1. Applying for registration of the enterprise while applying for micro enterprise start-up loan.</li> <li>2. The micro enterprise is established for less than a year.</li> </ol> <p><b>APPLICATION LIMITATIONS</b></p> <ol style="list-style-type: none"> <li>1. The enterprise must not have another business or the applicant must not be employed in another enterprise.</li> <li>2. The loan must be requested and registered by the person in charge.</li> <li>3. The loan must not be requested by people who receive pension from the military, public officials, professors, owners of public enterprises and any other pensions according to the Law.</li> </ol>	<ol style="list-style-type: none"> <li>1. Professional ability and applicant's ability to establish an enterprise.</li> <li>2. Future of the market</li> <li>3. Increase of employment</li> <li>4. Whether the enterprise can be operated continuously.</li> </ol>	<p>The total should not exceed 1,000,000 \$NDT</p> <p>The annual interest rate is 3 percent.</p> <p>The total term of the loan must not exceed 6 years. Interest is paid on a monthly basis.</p> <p>Maximum one year grace period.</p> <p>A person can request a loan more than one time.</p>	<ol style="list-style-type: none"> <li>1. Collateral is required</li> <li>2. SME Credit Guarantee Fund provides credit guarantee.</li> <li>3. A guarantor is also needed.</li> <li>4. It is processed according to credit review rules of local financial institution which offered the loan</li> </ol>

Source: department of Economy of Chinese Taipei



Start up loans can be used for buying or building a factory, purchasing machinery or as operating funds.

Government provides with assistance before granting the loans, during the application process, and after an enterprise obtained the loan. These actions are summarized in table N° 20.

#### 4. Current Status of Start up Loans

The statistic information available before May 31<sup>st</sup> 2005 reveals that 5,208 applications for start up loans were approved.

The total amount of approved loans was of \$NDT 4,334'740,000 where 60.02 percent were male applicants and 39.98 percent female applicants. 79.63 percent of total loans were granted to people between 45 and 55 years old, as shown in table N° 21.

When analyzing start up loans by industry, it is found that a greater portion goes to businesses (73.75 percent), then to social service (8.91 percent) and to manufacturing (5.49 percent). This is shown in table N° 22.

Aid provided by the government		
Assistance before the loan	Assistance provided during loan application	Assistance provided after obtaining the loan
■ Inquiries of establishing enterprise	■ Writing business plan	■ Guidance on operating
■ Professional technique training	■ Loan Inquiry	■ Guidance by industry
■ Aid provided by the government	■ Individual assistance	■ Evaluation and awarding

Source: Department of Economy of Chinese Taipei

Table N° 20  
Government Assistance

Achievement Analysis by Age		
Age	Number of people	Percentage (%)
45 - 50 years	2,453	47.10
50 - 55 years	1,694	32.53
55 - 60 years	671	12.88
60 - 65 years	390	7.49
Total	5,208	100.00

Source: Department Economy of Chinese Taipei

Table N° 21  
Analysis - By Age

Table N° 22  
Achievements Analysis - By Industry

Achievements Analysis - By Industry		
Industry	Number of Cases	Ratio (%)
□ Agriculture, forest, fishery, farming	36	0.64
□ Mining industry	5	0.10
□ Manufacturing	286	5.49
□ Water, electricity and fuel industry	4	0.08
□ Construction Industry	331	6.36
□ Business	3,841	73.75
□ Transportation, storage and communication	19	0.36
□ Finance, assurances and real estate	15	0.29
□ Service industry	207	3.97
□ Social service	464	8.91
Total	5,208	100.00

Source: Department of Economy of Chinese Taipei

Taking into consideration the nature of the business, 36.36 percent of these loans went to wholesale commerce as shown in table N° 23.

Table N° 23  
Current Situation of the Start Up Loans

Current Situation of the Start Up Loans			
Nature of Business	Number of cases	Amount (10.000 dolares)	Porcentaje (%)
<input type="checkbox"/> Food	893	70,148	16.28
<input type="checkbox"/> Services	246	20,525	4.46
<input type="checkbox"/> Wholesale	1,830	153,921	36.16
<input type="checkbox"/> Sale	504	42,262	8.98
<input type="checkbox"/> Manufacture	281	25,441	5.51
<input type="checkbox"/> Convenient Store	27	2,210	0.51
<input type="checkbox"/> Beauty Salon	70	5,894	1.35
<input type="checkbox"/> Other	1,357	113,073	26.76
<input type="checkbox"/> Total	5,208	433,474	100.00

Source: Department of Economy of Chinese Taipei



# Conclusions

## 5. Conclusions

- The trends of the finance institutions are: facilitate financing («Informalize»), use of credit rankings and/or guarantees to overcome the problem of assimilation information. Finance institutions tend to be bigger.
- The main microfinancing institutions that operate in Chinese Taipei are mutual savings and credit cooperatives.



# CURRENT SITUATION OF THE MICROFINANCE INSTITUTIONS IN KOREA

*Hong- Kee Kim*

## 1. Current Status of Micro-finance Institutions in Korea

Microfinance is the supply of loans, savings and other financial services awarded to micro-enterprises.

Micro-entrepreneurs usually have limited access to the formal finance market due to inherent characteristics and constant changes in financial markets.

### 1.1 Trends in Finance Institutions

The trends in finance institutions are.

- 1) The existence of asymmetric information between lenders and borrowers. Financial institutions use credit rankings or collaterals to overcome this problem. In this process, micro-enterprises have difficulties or disadvantages when receiving financial services.
- 2) Financial institutions are becoming larger in size on the belief that small loans convey high costs. Since these institutions are looking for the biggest clients, small loans and/or credits are not attractive for them.
- 3) The use of IT (Information Technology) in Finance is a fast and ongoing process. For example, new financial techniques and credit cards have increased rapidly. This makes even harder the access to financial institutions by people of limited resources since their access to IT is also limited (e.g. having a computer, paying the cost of internet service).

### 1.2 Micro-finance Objectives

The objectives may be explained by the following:

- To improve the access to financial market by less favored people
- To decrease the income gap between the rich and the poor
- To improve the network of social security
- To diminish financial market imperfections

## 2. Current Status of Micro Finance Institutions in Korea

Korea has many financial institutions. These include micro finance institutions such as Mutual Savings Banks and Mutual Finance Cooperatives.

### 2.1 Mutual Savings Banks

Mutual Savings Banks were formally established in 1972. They were oriented to enlarge loans for people and micro-enterprises who had been disfavored by the formal financial market. This activity has been regulated and supervised by the government so that participants are protected and access to financial market is promoted.

Since the financial crisis in 1997, the number of Mutual Savings Banks has decreased. The reasons respond to restructuring processes like the exit of bankrupted entities. Therefore, the number of Mutual Savings Bank fell from 231 in 1997 to 109 in 2004.

Total assets, deposits and loans in Mutual Savings Banks decreased at first since there was little confidence after a financial crisis, but recovered later in 2003. This situation is showed in chart N° 48.

Deposits of less than 50 millions won have been increasing and the shares of such small deposits is swinging near 81 percent in 2004. The average amount of deposit is 15 millions won (15 thousand dollars in 2004).

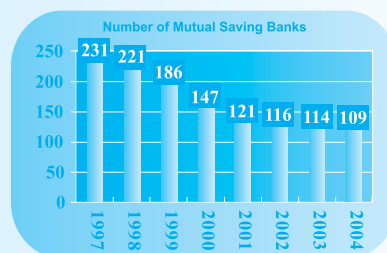
The profit of Mutual Savings Banks changed from a deficit situation to a surplus one in 2002 but are currently decreasing.

This is happening because Mutual Savings Banks are losing competitiveness while commercial banks provides multiple financial services at low interest rates.

The ratio of bad loans increased from 19.6 percent in 2003 to 21.2 percent in 2004.

The ratio of unpaid loans is also very high considering that in commercial banks is around 8 percent.

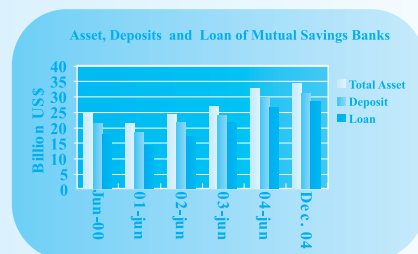
#### NUMBER OF MUTUAL OF SAVINGS BANKS IN KOREA (1997 – 2004)



Source: Document prepared for the Symposium of APEC  
Elaborated by: Mr. Hong Kee Kim

Graph N° 47  
Number of Mutual Savings Banks in Korea (1997-2004)

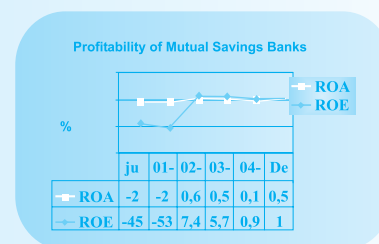
#### ASSET, DEPOSITS AND LOANS OF MUTUAL SAVINGS BANKS



Source: Document prepared for the Symposium of APEC  
Elaborated by: Mr. Hong Kee Kim

Graph N° 48  
Assets, Deposits and Loans of Mutual Savings Bank

#### PROFITABILITY OF MUTUAL SAVINGS BANKS



Source: Document prepared for the Symposium of APEC  
Elaborated by: Mr. Hong Kee Kim

Graph N° 49  
Profitability of the Mutual of Savings Banks

The increase in this ratio is derived not only from the sluggishly condition of business but also from structural problems like the decreasing of good clients. Consequently, Mutual Savings Banks are currently in a weak and vulnerable position.

## 2.2 Mutual Finance Cooperatives

Mutual Finance Cooperatives pursue mutual and common interests of members through the provision of savings and loans services. In Korea, they were established during 1972.

The Cooperatives manage deposits, loans, business in foreign currency and discounts of bills. Mutual Finance Cooperatives can only borrow from financial institutions, central credit cooperatives or government and limited to their own capital. A loan for a single person is maximum 15 percent of his/her capital with a required ratio of reserves of 10 percent.

There are five types of cooperatives:

- Credit Unions,
- Agricultural Cooperative,
- Fishery Cooperative,
- Forestry Cooperative
- Community Credit Cooperative.

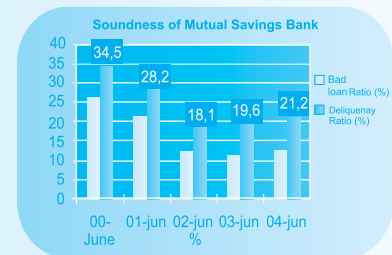
Since the financial crisis in 1997, the number of Mutual Finance Cooperatives has decreased. The reasons respond to restructuring processes and bankruptcies.

Therefore, the number of Mutual Finance Cooperatives decreased by 30 percent, from 6166 to 4277 as shown in chart N° 51

Total assets of Mutual Finance Cooperatives reaches \$228 billions as shown in table N° 24.

The ratio of unpaid loans decreased after the financial crisis thanks to restructuring processes. This ratio is 13.96 percent for credit unions, 17 percent for forestry and 10.56 percent for fishery.

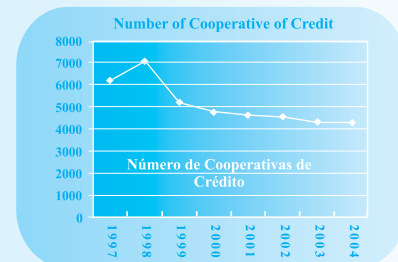
### SOUNDNESS OF MUTUAL SAVING BANK



Source: Document prepared for the Symposium of APEC  
Elaborated by: Mr. Hong Kee Kim

Graph N° 50  
Soundness of Mutual Saving Bank

### NUMBER OF MUTUAL CREDIT COOPERATIVES IN KOREA (1997 – 2004)



Source: Document prepared for the Symposium of APEC  
Elaborated by: Mr. Hong Kee Kim

Graph N° 51  
Number of Mutual Credit Cooperatives in Korea (1997-2004)

### ASSET OF MUTUAL CREDIT COOPERATIVES

Asset of the cooperative of credits (trillion of dolares)								
Entities	1997	1998	1999	2000	2001	2002	2003	2004
Cooperative Credit	19	21	20	20	22	19	19	22
Cooperative Agricultural	—	—	86	94	101	112	112	148
Cooperative Fishing	—	—	—	8.4	8.45	8.9	9.2	10
Cooperative Selvicultura	0.6	1.1	1.4	1.6	1.9	1.9	2.1	2.3
Cooperative of Credit Community	29.7	32.8	3.5	36.6	39.6	41.5	43.9	44.9

Source: Document prepared for the APEC Symposium  
Elaborated for: Sr. Hong Kee Kim

Table N° 24  
Asset of Mutual Credit Cooperatives

In comparison, the ratio is 7.45 percent for agricultural cooperatives and 10.4 percent for community credit cooperatives which are lower than other credit cooperatives.

Concerning the ratio of bad loans, it decreased rapidly until 2002 and started increasing in 2003 slowly but constantly, as shown in Table N° 25.

### 3. Social Solidarity Bank

Restructuring processes during the financial crisis led to high unemployment and then to scarce job opportunities due to low economic growth. This increased the gap between the poor and the rich and the number of micro-enterprises grew significantly. The increasing financial exclusion of the poor is due to the lack of collateral, unstable jobs and unpaid loans.

The Social Solidarity Bank was established in December 2002 and was supported by the Ministry of Health and Welfare. It is the only micro-credit bank in Korea and it aims to help the poor and micro-enterprises through loans, training and consultancy for entrepreneurs.

Currently its operation is limited because of its short existence. It has helped 176 families and 96 micro-enterprises. Loans are offered without guaranties up to \$2,000 with an annual interest rate of 6 percent.

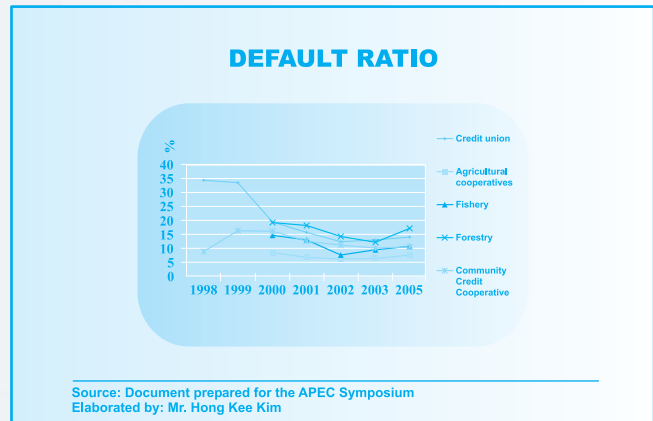
Activities were enlarged recently, and alliances with other commercial banks were established e.g. alliance with Bank of Choheung. This bank keeps aside 5 billions won (US\$5 millions) for micro-credits. The ratio of unpaid loans is only 3 percent with a decreasing trend in the long run.

### 4. Government Loan Guarantee for Micro Enterprises

In 1996, provincial and central governments established regional credit guarantee foundations in order to provide financing to micro enterprises. Today, sixteen provincial governments operate credit guarantee foundations in each province. Each one of them is responsible of managing the foundation.

The limit of the guarantee is up to 400 millions won for each micro enterprise. Each year, a total of 1.5 trillions won are used to provide credit guarantee for micro enterprises in Korea.

Guaranties for regional credit are mainly used by small services enterprises, unlike funds of credit guarantee or guarantee funds of technological credit, which are used mostly by manufacturers.



Graph N° 52  
Default Ratio

	1998	1999	2000	2001	2002	2003	2004-6
Cooperative Loan	15.59	15.63	12.24	9.7	6.19	6.3	6.97
Agricultural Cooperative			6.45	3.59	2.52	2.22	2.48
Fisheries			9.68	8.23	2.79	3.29	3.73
Forestry			5.7	6.1	3.2	2.8	3.4
Community credit cooperatives	14.5	14.2	10	7.9	6.7	5.4	6.7

Fuente: Documento preparado para el Simposio de APEC  
Elaborado por: Mr. Hong Kee Kim

Table N° 25  
Bad Loan Ratio of Mutual Credit Cooperatives (%)

The foundation of guaranty for regional credit has provided 210,000 businesses with credit guarantees for a total of 7 trillions won since 1997. These institutions plan to expand their credit guarantee service. The evolution of the number of benefited businesses by guaranty foundations for regional credit is shown in table N° 26.

## REGIONAL CREDIT GUARANTEE FOUNDATIONS

Foundation of guaranty for regional credit								
Year	1997	1998	1999	2000	2001	2002	2003	2003
□ Business number benefited	1,298	3,234	14,072	22,590	-32,276	40,198	49,849	48,529
□ (Accumulated)	-1,712	-4,946	-19,018	-41,608	-73,884	-114,082	-163,931	-212,448
□ Amount	1,030	2,019	5,031	8,027	11,206	12,543	14,839	15,067
□ (Accumulated)	-1,468	-3,487	-8,518	-16,545	-27,751	-40,294	-55,133	-70,199

Source: Document prepared for the APEC Symposium  
Elaborated by: Sr. Hong Kee Kim

Table N° 26  
Regional Credit Guarantee Foundations

# Conclusions

## 5. Conclusions

- Before 2002, Korea did not have financing institutions to provide financial services for the poor people and micro enterprises.
- Recently, government and NGOs have recognized the need of micro financing. This reflects the increase of the income gap between the poor and the rich. Many poor people have limited access to formal financial market. In particular, it has increased the number of bad creditors which constitutes both a problem and a social concern.
- In 2002, a micro loan bank called social solidarity bank was established, but its assets size and scope of activity are still very limited. Micro finance has got an opportunity ahead for rapid development and active operation. Then, this bank is just one step towards a long path.



# GUARANTEE MECHANISMS TO FACILITATE LOAN ACCESS TO MSEs IN PERU

Mr. Edgard Coquis Fernandez Davila

## 1. Background

The Foundation for Guarantee Fund for Loans to Small Industry (FOGAPI by its initials in Spanish) was formed as a branch of the Bank of Industrial Fostering in Peru (at the present, in liquidation). The initial objective was to help small enterprises and productive sectors and later, has broadened its scope of the foundation to micro-enterprises and other economic activities

FOGAPI is an institution with 25 years of history and supervised by the Superintendence of Banking and Insurance (SBS).

Historically, guarantee systems have been support tools used in developed economies like United States, Japan and the European Union.

These have developed government policies because guaranty systems are instruments of economic development generating employment and job opportunities as well as entrepreneurial projects, among others.

In Peru, a constitutional basis exists for the creation of Guarantee Funds for MSEs, as stipulated in the last paragraph of article N° 59 in the Peruvian Constitution. It states that: «The State provides improvement opportunities for sectors that are less fortunate; in this sense, it promotes small enterprises».

### 1.1 Perspectives

FOGAPI maintains strategic alliances with the Chambers of Commerce of Lima and Regional Governments. The headquarters are in Lima. Additionally, FOGAPI works with the Chamber of Commerce of Lima in Los Olivos, with PROMPYME, and the COFIDE Center and in the provinces with COF Renom, FOGAPI-Trujillo, Regional Government of Trujillo and the Chamber of Commerce, Industry and Tourism of Ucayali.

MICRO AND SMALL ENTERPRISES (MSEs) HAVE LITTLE OR INSUFFICIENT GUARANTEE WHICH RAISES THE NEED OF CREATING GUARANTEE SYSTEMS, AS PART OF THE NATIONAL FINANCIAL SYSTEM IN ORDER TO FACILITATE LOAN ACCESS FOR THIS SECTOR.

THE MAIN OBJECTIVE OF GUARANTEE SYSTEMS IS LOAN ACCESS FOR MSEs AND THEIR INTEGRATION TO THE FORMAL FINANCIAL SECTOR.

## 2. Guarantee Systems

- Guarantee programs.
- Guarantee funds.
- Guarantee Institutions.

### 2.1 Guarantee Programs

Guarantee programs allow public organizations to develop predetermined economic activities in specific geographic areas. A concentration of risk is present since they are related to one sector and circumscribed to a specific geographic area.

These programs keep limited financial resources from governments and work through the «first floor» banking. They perform credit evaluations, approvals, formalizations and loan paybacks through intermediary financial institutions (IFIs) that regularly operates in the financial system.

### 2.2 Guarantee Funds

These funds are temporary by nature and created by a governmental rule, generally a Supreme Decree.

Their «first floor» activities are developed through IFIs and their financial resources are limited to government sourcing. These funds develop indirect credit activities (guaranties) in a much broader sense than guaranty programs which are specific.

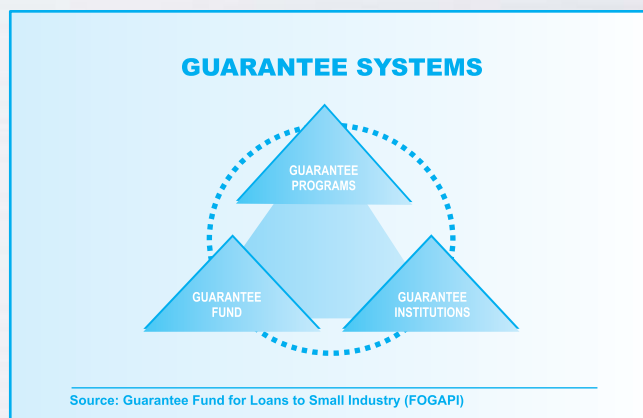
### 2.3 Guarantee Institutions

Guarantee institutions or societies develop their activities through any legal mean allowed by law. For example: the National Guarantee Fund (FNG) acts as an corporation in Colombia, while FOGAPI in Peru acts through its foundation.

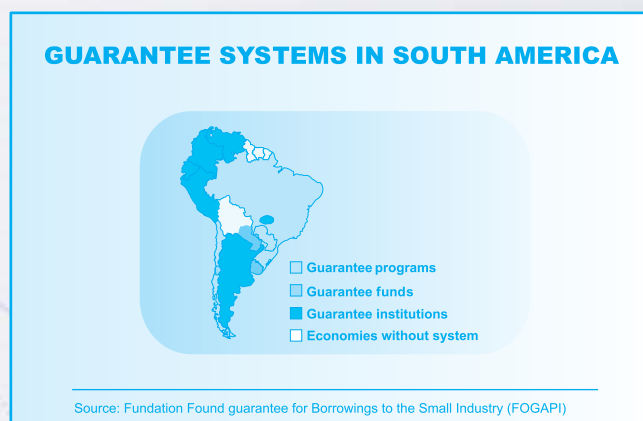
They develop guarantee services such as:

- First floor services: They execute credit (loan) evaluation, approval, formalization and loans payback.
- Second floor services: They develop mechanisms of extra guarantee and retroguarantees.

The guarantee institutions are regulated and supervised by the competent authority. It is indispensable for the consolidation of a guarantee system in national funds, the extra guarantee.



Graph N° 53  
Guarantee Systems

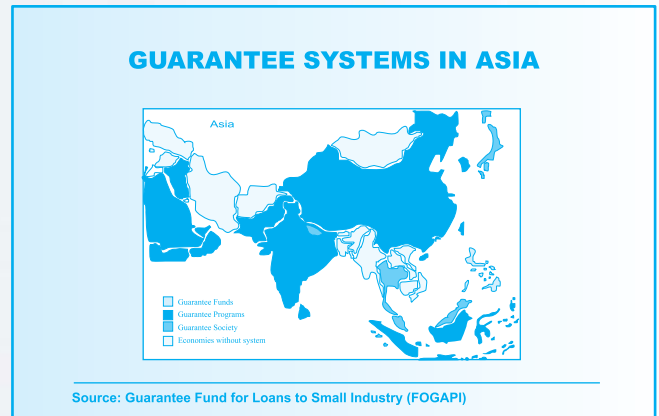


Graph N° 54  
Guarantee Systems in South America

The guarantee institutions are of public or private nature, even of supranational nature. Guarantee systems in South America are shown in graph N° 54.

In Latin America, the growth of these institutions occurred with the incorporation of a guarantee mechanism called «Guaranty Service Portfolio.» This mechanism is the «star» product of FOGAPI and similarly in Colombia and Chile

In Europe, Asia (Japan) and North America (United States) these systems are still on expansion, even when they are already developed to a significant degree. Graph N° 55 shows guarantee systems in Asia.



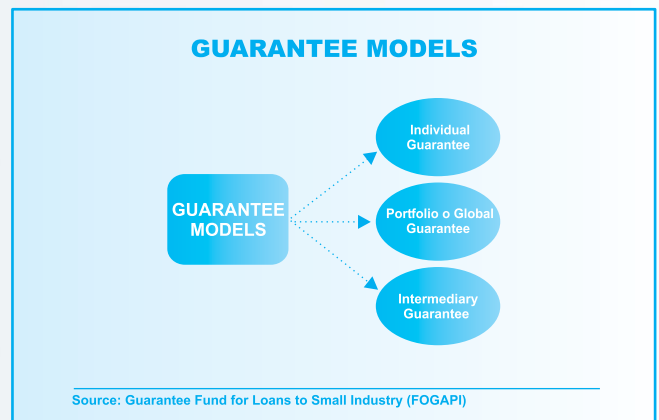
Graph N° 55  
Guarantee Systems in Asia

### 3. Guarantee Models

In Latin America, guarantee models are classified as follows:

- i) Individual guarantee.
- ii) Portfolio or global guarantee
- iii) Intermediary guarantee.

These models are shown in Graph N° 56.

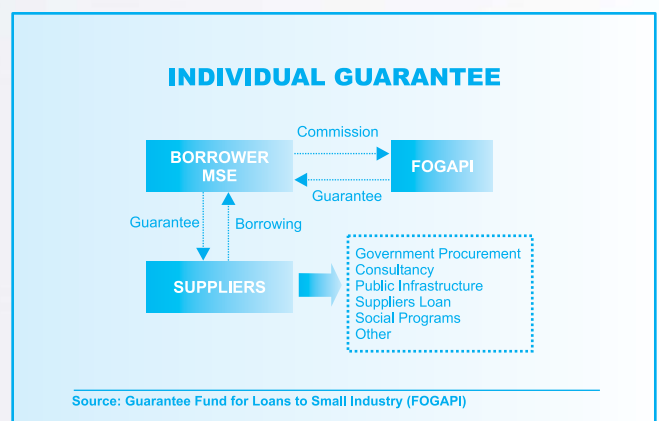


Graph N° 56  
Guarantee Models.

#### 3.1 Individual guarantee

It consists on granting a guarantee through a letter of indemnity and keeps direct contact with MSEs. This type of guarantee allows MSEs to access the following: supplier loans, guaranties on advanced payments of contracts, guaranties of contracts fulfillment, additional guarantee for differentials and complementary services.

In this model, a «first floor» system is developed between the MSE borrower, FOGAPI and suppliers as shown in chart N° 57.



Graph N° 57  
Individual Guarantee

#### 3.2 Portfolio or Global Guarantee

The portfolio or global guarantee is a finance mechanism, though which an agreement is signed with regulated financial institutions so they provide loans to service MSEs.

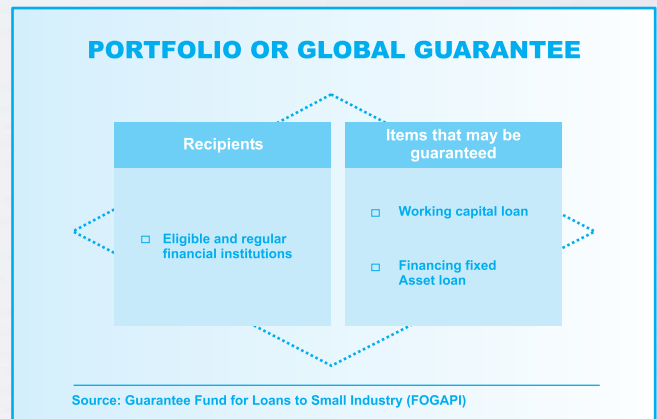
Beneficiaries of this guarantee are those financial institutions regulated and eligible in the institutional portfolio of the Financial Corporation of Development (COFIDE by its initials in Spanish). Graph N° 58 shows the loans that may be guaranteed with this instrument.

The portfolio or global guarantee maintains a loan coverage of loans up to 62.5 percent of remaining capital.

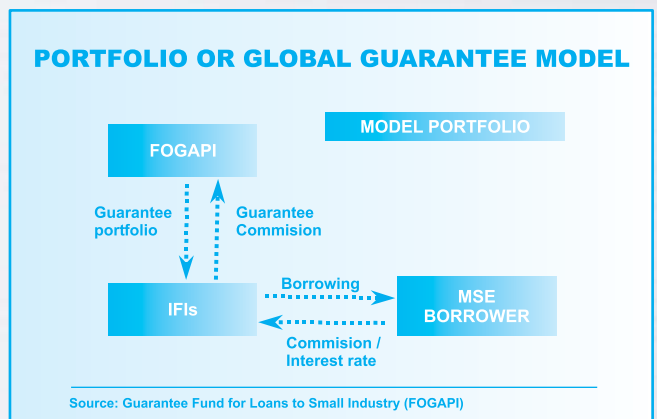
When the guaranteed part becomes insolvent, a 20 percent of the capital is required as a payment / recovery of credit for honoring. This is a healthy and innovative rule (that México and Colombia do not have) because it avoids relaxing the credit evaluation, since it would be very strange that a procedure ends at the beginning of its approval. Therefore, the effective coverage is 50 percent (62.5 percent of the remaining 80 percent of the capital).

This model is developed between the MSE borrower, FOGAPI and other financial institutions, as shown in chart N° 59.

The advantages for IFIs, MSEs and the government are explained in the following table.



Graph N° 58  
Portfolio or Global Guarantee



Graph N° 59  
Portfolio or Global Guarantee Model

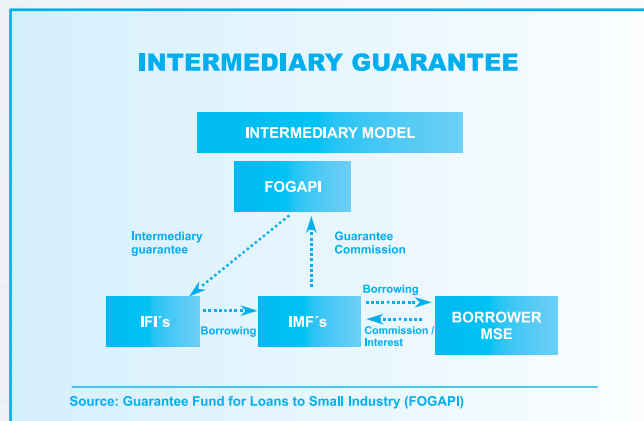
Table N° 27  
Advantages of Portfolio or Global Guarantee

Advantages of Portfolio Guarantee		
IFIs	MSE's	The Government
1. It reduces, shares and diversifies the credit risk with FOGAPI.	1. It offers better possibilities to access formal credit or improves their conditions to access loan.	1. It increases the Gross Domestic Product.
2. It turns the covered credit risk into capital by brief and prompt payment.	2. It mitigates the requirements guaranty	2. It generates job positions.
3. It increases the volume of its operations	3. They complement guarantees.	3. It collects more taxes
4. It reduces the default level	4. They improve their competitiveness in the market.	4. It supports decentralization of loans in Peru
5. It frees provisions to the IFIs on the counterpart risk. The provision is assumed by FOGAPI / Res SBS N° 808-2003.	5. It allows the generation of greater production and productivity	
6. It participates in FOGAPI's service guaranty, portfolio without providing a contribution	6. It does not need to present twice financial or accounting documentation	
7. It refunds FOGAPI it when recovers the money at zero cost.		5. It massifies loans.
8. It allows to be anchored to improve its capacity of indebtedness	7. It reduces the financial cost by minimizing the risk component of the interest rate.	
9. It protects the main assets loan portfolio.		
10. It allows developing technologies to service different MSE's loans.		

Source: Guarantee Fund for Loans to Small Industry (FOGAPI)

### 3.3 Intermediary Guarantee

Through this guarantee, institutions providing loans to the MSE sector are allowed to take resources of the financial sector (IFIs) because they are guaranteed by FOGAPI. This instrument can be used by non-profit organizations and enterprises of MSEs development (EDYPYMES by its initials in Spanish) which are all regulated and supervised by the SBS.



Graph N° 60  
Intermediary guarantee

### 3.4 Relevant Statistics

The number of operations during 1980-1996 was of 7,559, representing 2.69 percent of total operations. During 1997-2004 the number of operations increased to 273,838 which represent 97.31 percent. The table that follows shows the above information.

Emission of N° of Operations 1980 - 2004		
Years	Number of	% of operations
1800 / 1996	7 559	2,69 %
1997 / 2004	273 838	67,31 %
Whole	281 397	100,00 %

Source: Guaranty Fund for Loans to the Small one Industria FOGAPI

Table N° 28  
Relevant Figures

# Conclusions

## 4. Conclusions

- «The guarantee is the loan access accelerator in favor of the MSEs.
- FOGAPI has three different guarantee models: individual guarantee, portfolio or global guarantee and intermediary guarantee. With these mechanisms, the financial and microfinancing institutions keep a direct relation with MSEs achieving an important financial coverage.

## PANEL IV:

### FORMALIZATION AND FINANCING IN THE MICRO AND SMALL ENTERPRISE SECTOR IN THE APEC REGION

**Theme:** FORMALIZATION AND FINANCING IN THE SECTOR OF THE MICRO AND SMALL BUSINESSES OF APEC.

**Dr. Fernando Villaran**, international consultant, former Minister of Labor and Employment Promotion of Peru.

# FORMALIZATION AND FINANCING IN THE MICRO AND SMALL ENTERPRISE SECTOR IN THE APEC REGION<sup>11</sup>

Fernando Villaran<sup>12</sup>

## 1. Introduction

Micro, Small and Medium sized Enterprises (MSMEs<sup>13</sup>) constitute the backbone of APEC economies for they employ as much as 80 percent of the work force, contribute between 30 to 60 percent of GNP and account for about 35 percent of total exports in the region. They also make up for over 95 percent of all the enterprises. Recognizing this, APEC established the Small and Medium Enterprise Working Group and the Micro Enterprise Sub-group whose main objective is to encourage the development of the MSMEs in all member economies.

The APEC Ministerial Meeting held in Santiago, Chile, on November 2004, approved the Project SME 01/2005 - Micro and Small Enterprise Financing: a Tool for Mainstreaming the Informal Sector? The project included a two day symposium in Lima - Peru held on July 6-7th where APEC economies shared best practices and discussed strategies to promote small and micro enterprises' formalization and financing in the APEC Region. It also involved the preparation of the present document that summarizes the results of the Project, achieved objectives and recommended actions that will foster formalization.

Informality and the policies and strategies needed to overcome it, have been in the economic development agenda of the APEC economies, in the academic discussions and in the political environment for decades. However, there is a wide consensus on the complexity and depth of the issue that has led to several interpretations of the ultimate causes of why informality exists. In developing economies, poor people looking for jobs in the formal sector and being unable to find them are forced to engage in economic activities, such as self employment and in micro enterprises, in order to obtain incomes for them and their families. Generally working in traditional sectors, as agriculture, commerce and services, with low productivity, where the entry barriers, in terms of knowledge and capital, are low.

Many of these self employed, micro and even small enterprises (MSEs) operate without legal recognition or government awareness mainly because of high compliance costs, in terms of

<sup>11</sup> This document was elaborated by the consultant for Project SME 01/2005: Micro and Small Enterprise Financing: a tool for mainstreaming the informal sector? and presented in the symposium.

<sup>12</sup> Industrial engineer and master in economics, former Labor and Employment Promotion Minister of Peru, currently international consultant for SASE. The author wants to thank Vanessa Banchemo and Mauricio Osorio from PROMPYME and Karin Talavera from the Ministry of Production for their cooperation and comments.

<sup>13</sup> In the following lines, we will use MSMEs for micro, small and medium enterprises; MSEs for micro and small enterprises, and SMEs for small and medium enterprises, which is the most common denomination.



administrative and legal procedures which constitute barriers for the formalization process of these firms or individuals and their assets. While in developed economies, business formalization is the starting point of any business, in developing economies, it never occurs or constitutes an «end point», particularly when business growth makes them challenge the costs and obstacles of being informal. The disadvantages associated to business informality usually are: limited access to credit, market opportunities and services, police harassment and legal instability, and scarce knowledge of the property rights of their assets. These elements in turn, become constraints for their economic growth, productivity increases and improvement of labor conditions.

Business informality and the absence of property rights is usually shown as the main cause of the lack of access to financing, essential for their growth. However, the problem is more complex: information asymmetries, qualitative uncertainty and the moral hazard perception also constitute barriers to financing. In a financial market where information on potential creditors is partial or non-existent, where there are no formal parameters to evaluate the risk of allocating resources to informal enterprises and where market information is limited, there are obviously less possibilities to facilitate credit access to informal enterprises. However, microfinance and micro banking institutions, despite these conditions, have been able to develop financial technologies that reduce risks based on the knowledge of the behavior of the entrepreneurs and their small businesses, using trust social nets close to them. In order to provide loans, even to informal enterprises and individuals, microfinance institutions place a higher value on the behavior and financial culture of the creditor and are willing to build from them their financial record.

However, it is also true that the possibility of accessing capital particularly as enterprises demand more and diverse financial services, can be a powerful stimulus for enterprises to become formalized and benefit from resources that can help them achieve economic growth.

Therefore, APEC economies, considering the reality and the relative development of each economy and its regulatory framework, have in their public policy agenda the task of becoming acquainted and sharing adequate mechanisms that facilitate the micro and small enterprises formalization and access to financing services. Developed economies have important successes in both fields that are worth studying and sharing. The developing economies have partial accomplishments and can exchange experiences on the most successful formulas for micro and small enterprises' development, formalization and access to credit.

In the preparation of the APEC Symposium a survey was designed to get an actual and clear picture of the situation of the micro and small enterprise sector, its relation with informality, and the role of financing in the formalization process. The survey was divided in three parts: (i) official definitions of micro and small enterprises, (ii) understanding of informality in each economy, and (iii) financial services for MSEs and their relation with formalization. Unfortunately only 12, of the 21, economies members of APEC answered the survey. In the next section a short background, which includes the ongoing theoretical discussion in informality and MSMEs, is included. Followed by the presentation and analysis of the results of this survey.

## **2. Background**

Informality, in the one hand, and micro and small enterprises (MSEs), in the other hand, are very closely related concepts. In many ways, they refer to the same economic and social groups. A vast majority of micro enterprises, much more self-employed, and even many

small enterprises, are informal. They have no legal recognition, pay no taxes, meet no labor regulations, and confront severe difficulties in their access to credit, markets, technology and police protection.

Yet, these two concepts are also very far away<sup>14</sup>. In many economies informality is seen as underground, illegal and even evil (they exploit workers and use child labor) activities that has to be repressed and eliminated. It is also associated with bad quality, no word keeping, chaotic behavior, that also should be eradicated. Even the actors themselves don't like to be related with informality, not to say being called so. In the other side of the road, micro and small enterprises are seen as part of the private sector, which is considered formal by nature. They have official agencies that support them and have a lot of programs and services oriented to foster their growth and modernization. Increasingly, they are being seen as the entrepreneurial engine of growth, the main source of new employment, the main actor in local and regional development, and also a social sector that contributes to a more equitable society. Dr. Jekyll and Mr. Hyde, both in the same economic and social sector.

How do we arrive to this dilemma? One line of explanation is the origin of both concepts. Informality has been created by independent researchers like Hart, Bhalla, Sethuranam, Mathur and De Soto, trying to explain the characteristics and causes of the new economic and social phenomenon erupting in big cities all over the developing world. Even the International Labor Office (ILO) supported to this research effort. It certainly had a lot discussion going along with the universal expansion of the concept, being also a sign of its vitality and actuality. To this day, two visions of the informal sector stand alone with force, and account for memorable discussions: (i) the ILO vision of a informal sector in which workers are forced to enter against their will because they do not find jobs in the formal sector, and (ii) the De Soto vision of a informal sector entrepreneurs expanding a dynamic (and real) market economy fighting against the bureaucratic and oppressive state colluded with the so called «mercantilist» capitalists. It is also true that both visions have been tempered by the years and further researches, evolving with the inclusion of each other's findings and policy proposals.

On the other hand, the small enterprise concept (and the following micro enterprise one) was born in the comfortable offices of government agencies and development banks. In developed economies, mainly post war Europe and Japan, it was a matter of reconstructing their economy helping the small enterprises to recover and grow. In the developing economies, the small enterprise concept was delayed because of the import substitution industrialization (ISI) strategy, enforced in the sixties in Latin America and many other economies. It was based in large enterprises, being mainly state owned and foreign investment. It is in the late seventies and early eighties, when the ISI model entered in crisis and unemployment raised, that eyes began to pose on the small enterprise sector. In both cases, developed and developing economies, the small scale enterprises were considered part of the private sector, with only a size difference with the big enterprises. Both sectors were formal and part of the economic and institutional establishments. The United Nations Industrial Development Organization (UNIDO) exemplifies this approach, creating and executing a number of programs and services directed for the development of SMIs<sup>15</sup> all over the world. The link between small and medium size enterprises pictured in the SMI concept which extended all over the world, proofs the bias toward bigger and formal enterprises, moving away of the smaller and informal

<sup>14</sup> The lines that follow are heavily influenced by the results of the mentioned survey, whose results are presented in the following section, particularly by gathered information that indicates that for the majority of APEC SMEs agencies informality is not a problem.

<sup>15</sup> In this paragraph considering that UNIDO uses the term SMI for Small and Medium Industry, the «I» for Industry is used instead of «E» for Enterprise that has been used though out the document.

ones. Another problem with this approach is the concentration on industrial enterprises, which many official agencies still have, leaving out of the picture commerce and service sectors that are much more important in terms of number of firms, employment and turnover.

At the end, we have two separate worlds: the informal sector with its own researchers, practitioners and institutions, and the SME sector with its own environment, and very little relation between both. This situation is not good for anyone. Even though the SME concept and institutions have been evolving and being increasingly important in government policies and budgets, it has been kept enclosed in governmental and sector quarters. On the other hand, the informal concept has evolved much more quickly, particularly in developing economies, and an increasing number of economies are dealing with it at the highest level possible<sup>16</sup>. Another important evolution of the informal concept is that multilateral institutions like the World Bank (WB), the Interamerican Development Bank (IDB) and others are giving increasing attention to the informal sector, both in its macroeconomic policies, and their support to microfinance institutions and Business Development Services (BDS). More and more governments pay increasing attention to the informal sector and include it in their strategic planning and macroeconomic policies. It is true that SMEs policies and institutions are also being supported by governments and international institutions, but their scope and dynamism are much lesser. The danger here is that some governments and international institutions, confronted with increasing social unrest, would design policies and programs for the informal sector leaving SME sector out of the loop. Probably this won't happen in all the APEC economies, but the only possibility that it can occur in some of them is sufficiently important to deal with the issue.

The SME agencies and related institutions (including the business unions) have to react and pay increasing attention to the informal sector. To start, they must learn more about it, relate with the institutions of the informal world, interchange information, policies and programs hoping to have joint activities, and hopefully in the future, joint policies and programs.

One of the most promising fields for the exchange of experiences is financing MSEs because much of this activity is done with informal clients. It is precisely the microfinance institutions that attend both informal and formal MSEs, and contribute largely in the formalization of the former. Lessons learned by them can be translated to other fields, although this is not a straightforward and easy task.

In the lines that follow, the results of the survey applied to APEC economies will be shown. They explore the complex and close relations between informality and MSE sector, and even considering that we are dealing with just some aspects of it, the final product is very useful and relevant.

### 3. Survey results

The survey was answered by 12 out of 21 economy members of APEC, (A summary is presented in Annex 1) and even if they represent just half of the economies, the results are very interesting and useful. The economies whose information is being account for and analyzed in the following lines are: Indonesia, Philippines, Chinese Taipei, Canada, Chinese Hong Kong, Japan, Brunei Darussalam, Chile, Mexico, Australia, Republic of Korea and Peru<sup>17</sup>.

<sup>16</sup> This is the case of Mexico, Egypt and other economies whose presidents are receiving the advice De Soto's institution (ILD)

<sup>17</sup> We want to thank all the SME agencies and governmental institutions that dedicated their time and expertise in answering the survey.

### 3.1 Informality and its importance

The most striking answer to the survey is certainly the one referred to informality. When asked if the economy considers informality a problem, 5 economies answered No, 2 economies did not answer, and only 5 economies answered Yes. This means that only 42 percent of the APEC economies in the survey consider informality a national problem. These answers contrast greatly with recent studies made by ILO and others that show with no shadow of doubt that informality is growing all over the world<sup>18</sup>. With rare exceptions we are facing a world tendency<sup>19</sup>, in which informality is being considered increasingly as a major problem, mainly in developing economies but also in developed ones. In the first group of economies informality accounts for the majority of firms and employment, and also significant percentages of their GNPs. In the second group, the participation of the informal sector is still low, but it is clearly growing, being considered as the underground, black and/or illegal economy. The answers in our survey also contrasts with the national studies and researches made at the national level in many of these same economies<sup>20</sup>. Even more, some economies, that in the survey account for significant presence of informality in their MSE sector have answered that it is not a problem.

One explanation for this apparent contradiction is that the SME agencies that were responsible for answers in the survey do not handle current information about the informal sector and therefore are not aware of its importance. Complementary to that, probably these agencies don't have close relations with the institutions dealing with this problem in their own economy. As was stated in the previous section, this can certainly happen because the world of SME agencies is the formal one and little to do with the informal world.

This distance with the informal sector and its problems is confirmed when another 36 percent of the answering economies do not have a definition for informality. 58 percent defined informality as «the set of economic units that do not comply with government imposed taxes and regulations». Some economies (3) also define informality as «economic units with low productivity and income». Being a very complex phenomenon, there is, of course, room for many definitions of informality, that go far beyond the general ones that have been mentioned. In the specific answers to this question, definitions focus around official recognition, as can be seen in the following: «informal enterprises are the ones that have no legal registration in government offices», «enterprises that do not pay taxes and do not have functioning permit from the local government»

When it comes to explaining the causes of informality, some of the reasons given were the following: «cumbersome bureaucratic procedures, costly requirements, red tape and bribes», «lack of assets in population hands, and limited employment opportunities by the economy», «poor enabling environment for private enterprises, and even environments oriented to support state owned enterprises», «informality grows when unemployment rate goes over 5 percent», «some entrepreneurs think their business is so small that it is not necessary to register», «lack of opportunities and low wages», «general disinformation about the benefits of being formal», «high unemployment and poverty rates», «formality is too expensive». They can be arranged in three groups:

<sup>18</sup> «Against the first predictions, the informal economy has grown rapidly in almost every point in the planet, including industrialized countries, and therefore cannot be considered a temporal or marginal issue». Decent work and the informal economy, 90<sup>th</sup> International Labor Conference, ILO, Geneva, 2002.

<sup>19</sup> Schneider's work (2002) measuring the informal sector in 110 countries arrives to same conclusions as ILO's.

<sup>20</sup> The papers and books included in the references studies almost all the APEC economies.

(i) poverty, unemployment and lack of opportunities, (ii) red tape, state bureaucracy, and high costs of formality (as can be seen in Annex 2, that shows the World Bank Report on costs of formalization), (iii) disinformation and perceived lack of benefits in being formal. Although these causes are structural and have historic roots, and therefore won't be easy to tackle, the SME promotion institutions can help a lot in dealing with them. They can foster the creation of new firms and thus open opportunities for many. They can simplify registering and taxing procedures and other regulations, heavily reducing the cost of being formal. They can inform and promote the wide variety of services offered by themselves and other private or public agencies, thus showing the advantages of being formal.

Many economies did not answer the question about the importance of informality within the micro and small enterprise sector. The ones that did, show a very wide range of situations. In the upper end informality accounts for as much as 92 percent of the firms and 74 percent of the employment and 44 percent of the GDP. In the lower end, informality involves 30 percent of the firms, 20 percent of the employment and 5 percent of the GDP. A very important finding is that the informality is always lower in the small scale enterprises than in the micro enterprises, showing that the growth of the firms is inversely related with informality: the bigger the firm the lesser the informality. This finding has major implications with formalization policies for every APEC economy: a healthy promotion policy that fosters growth in the MSE sector is by far the best formalization policy. Self employment and micro enterprises, given their small scale of operation, can hide from the authorities, but small ones, with tens of workers, clients and suppliers, are seen easily by neighbors and local governments. In the positive side of the arguments, the bigger businesses need markets, credit and other services for which being formal is a prerequisite.

### 3.2 Micro and Small Enterprise Definition and Importance

As expected, this set of questions were answered by almost every one of the 12 economies. The variable mostly used to define enterprise size is the number of employees or workers. This is no surprise since it can be compared between different economies with very different characteristics. The other variable frequently used is the amount of sales, but the existence of different currencies and variable exchange rates make it difficult for an international comparison. This argument also stands for assets, a third variable also used in the definition of enterprise size.

The variety of definitions, in number of employees, is very wide. From a definition of micro enterprise for the ones that have from 1 to 2 employees, for an APEC economy to 1 to 100 employees for another economy. The definition for micro enterprise mostly used is the 1 to 10 employees; five economies used it. A second definition is the 1 to 5 employees; also four economies used (although in two cases the upper limit is 4 and not 5 employees).

In the case of Small Enterprises (SEs), definitions vary, from 3 to 10 employees for one economy to 11 to 300 employees in another. The upper limit for SEs most commonly used is 50 employees, followed by 100 employees.

The variety of definitions is notorious and contrasts with other economic blocks like the case of the European Union, that has a common definition of micro and small enterprises for all its economy members: 1 to 10 employees for micro enterprise and

11 to 50 employees for small enterprise (also 51 to 250 employees for medium size enterprise). This common definition creates a good ground to interchange studies and experiences, and most important design and implement common policies and support programs. This is not the case in APEC, since the member economies have very different definitions for micro and small enterprises which makes it very difficult for cooperative research and actions.

The APEC economies have important areas of cooperation explained in the «strategic policy framework» of the APEC SME Working Group document mentioned earlier, which deals with: (i) business environment, (ii) human resource development, (iii) technology, (iv) finance, (v) market development, and (vi) information dissemination. The cooperation also deals with programs aimed at the different stages of enterprise development, such as: (a) start-up, (b) growth, (c) expansion, and (d) going overseas. Although this cooperation is important and should be supported and enhanced, our point is that this process can be hindered by the very thin common conceptual framework described. This poses a major challenge for the APEC members: advance in the shortest term possible in establishing a common theoretical and conceptual ground, both in the MSME sector as in the informal one.

The above issues have close resemblance with OECD policies . The areas prioritized by OECD<sup>21</sup> economies are: (i) SME role in employment creation, (ii) Contribution to technological innovation, (iii) Flexibilization of the productive structure and the economies, (iv) Internationalization of SMEs, (v) Use of Information and Communication Technologies (ICTs), (vi) Environmental management, (vii) Entrepreneurship, (viii) Financing, (ix) SME management enhancement and training, (x) Networking, clusters and spatial development, (xi) Government policies and programmes.

When it comes to measuring the importance of the MSE sector in the economy, certainly the most important variable is the number of enterprises. The MSE sector accounts for 78 to 99.8 percent of all the firms in the APEC economies. In nine (of 12) economies MSEs means more than 95 percent of all the enterprises, and in 6 they represent more than 98 percent of all enterprises. The figures are different when comparing other variables. The MSE sector participation in employment generation has different results: from 20 percent to 99 percent, with an average of 56 percent for the 11 APEC economies that presented data. This is a pretty high participation and surely represents the variable that gives MSME sector such a high profile in development policies and programs. As expected, since micro and small enterprises have much less productivity than large and medium ones, the participation on the GNP is lower. It ranges from 10 to 50 percent, with an average of 29 percent. Finally, the fourth variable analyzed in this block is exports; the results show an MSE sector participation that goes from 1 percent to 25 percent, with an average of 7.5 percent. Clearly a small figure compared with the other variables in which the participation of MSE sector is much more significant, showing that export is still incipient and its promotion constitutes a major challenge, having a lot of room for progress in this field. At the end, the universal pattern for MSEs (and even MSMEs) all over the world is confirmed: huge participation in the number of total of enterprises, very big participation on employment, lower participation in GNP, and finally, a very low participation in exports. This pattern is explained by the productivity gap MSEs have with respect to big and medium size enterprises, and clearly

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<sup>21</sup> «OECD Small and Medium Enterprise Outlook», OECD Publication Service, Paris, 2002

shows the way to go in the design and direction of the promotion programs to the sector.

Looking at these four variables and the huge variations found in them, one can conclude that the economies in APEC have not only quantitatively different MSE sectors but also qualitative differences. Of course, this is no surprise since we have economies that range from 34,010 dollars of per capita annual income to 710 dollars<sup>22</sup>, but have significant implications for policy design. Even if practices for information and experience interchange within the APEC economies is very important and should be supported, from developed to developing ones and also among developing economies, the differences found tell us that we must be cautious in making generalizations.

At this point we can stop and try to look at both issues: informality and MSEs. With few exceptions, we have seen in the APEC economies that micro and small enterprises are very important, and also that informality is important, and that both concepts refer to more or less the same social and economic sector. Unfortunately, as stated before, policies and institutions dealing with these two concepts are very different and in many cases don't even coordinate at the national or local level. Finding that shows us the path to deploy efforts to close the gap between these two different institutional worlds.

### 3.3 Financial Services for Micro and Small Enterprises

As expected, we found a wide variety of financial institutions and programs aimed at the MSE sector in all of the APEC economies. As should be, considering financing being one of the most important inputs for enterprise sustainability and growth, regardless of its size. In 100 percent of the APEC economies (that answered the survey), commercial banks provide financial services to small scale enterprises, 91 percent of them provide them to micro enterprises. Showing, in the one hand, the importance of the sector to the financial formal world, but in the other hand, also showing that micro enterprises still are seen as risky by some commercial banks in a few APEC economies.

The services that commercial bank give to the MSE sector are many and cover almost the whole range of the known financial products, like loans, checking accounts, savings accounts, factoring, credit lines, money transfers, insurances, credit cards, among others. Some developing banks, second floor banks and even commercial banks, have developed credit guarantee funds, to reduce the risk factor in lending MSEs. The result is that more commercial first floor banks are willing to offer services for the sector.

Nine (out of 12) economies have microfinance institutions that service mainly the micro enterprise sector but also the small scale enterprise one. Here, the development issue is relevant: the more developed the economy is, less microfinance institutions they have, on the other hand, the more underdeveloped the economy is, the more microfinance institutions they have. In the latter ones, microfinance institutions have a greater presence in the financial market compared to the former ones. This is understandable, the former have a consolidated commercial financial system that can serve the small and micro enterprise sector they have in their economy, while the latter have a weaker financial system and a bigger micro enterprise sector which they can not tackle completely, hence the need to develop specialized institutions like the

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<sup>22</sup> These figures are for the year 2002 and come from the World Bank data base.

microfinance ones. Surely, microfinance institutions are created for micro enterprise financing, and even self employed, regardless if they are formal or informal (this is the rule in Latin-American institutions). They also attend small scale enterprises, and are doing so increasingly. The survey results show that there are more microfinance institutions that attend micro enterprises alone, but it also shows that these same institutions are increasingly attending small scale ones.

The service most commonly given by the microfinance institutions, and probably its trade mark since Junus's Grameen Bank, the father of the system, gave its first loan in Bangladesh, is certainly loans without collateral. As we know, microfinance institutions have very low arrears (much lower than commercial banks with bigger and formal clients) by making their loan decisions based mainly in good information and the moral capital of their future clients. This paramount characteristic of microfinance institutions makes it irrelevant if the MSE is formal or informal, and at the end a very large proportion of their loans go to informal businesses. In order to lend bigger amounts of money to their growing clients microfinance institutions are using also individual and family guarantees. A vast majority of microfinance institutions are born as NGOs, many stay in that condition, but a growing number of them upgrade themselves to formal and regulated financial institutions without losing its flexibility, financial technology and will to support the MSE sector.

Being Peru the guest economy and having one of the most dynamic microfinance sector in the world, it seems proper to present a short picture of it. Microfinance started in the year 1982, in which the first Savings and Loans Municipal Bank (Cajas Municipales de Ahorro y Crédito - CMACs) was created. The same year, the first financial NGO, called Communal Action (Acción Comunitaria), was also created. The first is today the head of a system of 12 Municipal Banks distributed in the major cities of the economy, the fastest growing group of the microfinance system. The second is today MIBANCO (translated to English MYBANK) the major commercial bank specialized in micro enterprises, leading the way for other commercial banks that are increasingly engaging with the MSE sector.

To this day Peru has 222 microfinance institutions<sup>23</sup>: 14 Municipal Banks (Cajas Municipales), 14 Institutions for the financing of SMEs -EDPYMEs (9 of which were former NGOs), 12 Rural Banks (Cajas Rurales), 2 Commercial Banks<sup>24</sup>, 20 Non supervised NGOs and 160 Credit Cooperatives. By May 2005 they all had 1,813 millions dollars in active portfolio, with a total of 1.32 million active loans, which represent more than one million active clients (a majority of which are micro enterprises). In the year 2002 the portfolio of these institutions grew 29 percent, in 2003, 28 percent, and in 2004, 34 percent<sup>25</sup>. During these years the Peruvian economy only grew 5 percent annually on average. The profitability (return over investment) of the Municipal Banks has been around 26 percent in the last four years. The profitability of the whole microfinance system is more than 20 percent, a performance without match in the whole Peruvian economy.

Venture Capital is an entirely different world as can be seen by the results of the survey. Only 5 economies (of 12), mainly the developed ones have this financial service

<sup>23</sup> Source: Bank and Insurance Superintendence - SBS

<sup>24</sup> MIBANCO and Banco de Trabajo

<sup>25</sup> Actually from may 2004 to may 2005



for the MSE sector. Four of them attend both small and micro enterprises, only one economy serve only the small scale enterprises. Being a modern, complex and sophisticated service it is no surprise that mainly developed economies have it. The explanation is twofold, in the one hand in developed economies there is much more available capital, investments and savings, in various forms, and in the other hand, there are more profitable opportunities in new businesses and projects. This service have a tremendous impact on new firms, both micro and small, therefore it is crucial that developing economy members of APEC learn from their more developed counterparts and install venture capital in their own economies. The experience shows the existence of both private and public funds. Most probably, for developing economies, the starting point would be a public fund, that can create the necessary confidence for the private sector to enter in this very risky business.

### 3.4 Best practices and innovative financial services for MSEs

As we have seen, all the APEC economies have a very wide variety of financial services and institutions for both, small and micro enterprises. Many of them also have dynamic microfinance institutions for the informal enterprises and working poor. The sustainable institutions involved, the services, the portfolios and the number of clients are growing everywhere and MSEs are benefiting from this process. In such a rich environment, the survey showed an important number of best practices and innovative financial services.

We have selected some of them<sup>26</sup>. Philippine's Barangay Micro Business Enterprises (BMBE) aims to integrate MEs from the informal sector to the mainstream economy by granting incentives and other benefits. Japan's National Life Finance Corporation lends without collateral to small enterprises, and contribute to enhance their management through guidance by management consultant from the Japan Chamber of Commerce and Industry. Chile's Law (19.749) for the Family Micro Enterprise has been very successful in the formalization of informal enterprises and family economic units. And the Credit Access Program (CAP) managed by SERCOTEC (an official institution for the promotion of MSEs) has benefited about 100,000 micro enterprises (30 percent informal) in three years. Peru's Micro Enterprise and Self employment Support Program (PRODAME) in the Ministry of Labor and Employment Promotion and the Micro and Small Enterprise Information Centers (CENTROMYPE) have helped the formalization process of thousands of micro and small enterprises. Explaining the details of these cases and exploring the secrets of their success exceed the scope of this paper, but we hope that in future meetings and workshops, economy members can present them, exchange information and produce the cross fertilization that lies at the heart of integration organizations like the APEC.

## 4. Main conclusions and policy implications

It seems proper to start with the Symposium's name: Is micro and small enterprise financing a tool for the mainstreaming of informal sector? The answer is definitively yes. We have reached this conclusion<sup>27</sup> indirectly. Even though we have found some cases in which financial services have contributed to MSE formalization we cannot affirm that all financial services

<sup>26</sup> Even though the survey doesn't gives details of the services, technologies and procedures in each of cases, our purpose in showing some of them is to foster information and experience interchange between APEC members.

<sup>27</sup> We must bear in mind that we haven't done a proper reseach on the symposium's issue, we only have in hand a survey answered by 12 economies and therefore the conclusions arrived are indicative and preliminary. At most they help us to find some problems, some solutions, and raise some questions, from which APEC or ist members can work upon.

produce this effect. But what we have found more conclusively is that financial services, delivered both by commercial banks and microfinance institutions, do contribute to micro and small enterprise growth. And also we have seen very neatly, that there is a direct and close relation between size and formality; the larger the size of the enterprise, the more formal it is. Then, in this way, an indirect way, financing does contribute with MSE formalization. We have found, also, that much more can be done in this field and that there is a very wide road to cover.

From the survey we can say that microfinance institutions work largely with informal MSEs, and for that their contribution with the formalization process is greater than of the commercial bank's. That is why with no hesitation we can recommend APEC economies to promote financial services aimed at the MSE sector, both from commercial banks and microfinance institutions, with the near certainty that they are not only contributing to the growth of this sector, with all the consequences in terms of employment, flexibility, innovation we know, but also they will contribute in the formalization process of MSEs. But we can also say that if governments have selected formalization as a major objective, they should promote and encourage microfinance institutions because they are very well suited for that purpose.

It is important to keep in mind that MSEs growth can also be accomplish with a whole array of services, such as training, information, market development, counseling, subcontracting, supplier building, among others. That is to say that in many cases financing is not necessarily the best way to foster MSEs growth and hence formalization.

Other conclusions that come out of the survey unfortunately are not so bright as the first one. We have found that in many APEC economies there is no full awareness of the magnitude and characteristics of the informal economy, at least this is not seen by the SME agencies that have answered the survey. A full 64 percent of the answering economies don't see the informal sector as a problem. We have called this a shocking finding since all evidences point that this sector is growing all over the world. This situation is no good for anyone, so it's imperative to take some actions: governments should try to coordinate their efforts in both, the MSE sector and the informal sector. In many cases, they have agencies dealing with each one of them. One can argue that maybe it is best to have two different policies and two different sets of institutions to deal with them, but since we are talking about the same social and economic sector (at least in the economies where the informal sector is important) this reasoning has no logic and economic rationale.

It is true that economies in the APEC region are very different and have different characteristics, so it is important to discuss common problems that hinder individual and collective development, and to search how member economies can help each other. That is to say that even if informality is a complex and controversial phenomenon it should be addressed by the APEC members, and probably the institutions more suitable of doing so are institutions already working with MSEs.

But the problem is worse, because even in the strict field of MSE promotion and institutions (without considering the informal sector), we found that there are very different definitions, measures and views of micro and small enterprises. While the European Union (EU) has reached a common definition for all its economy members, the APEC economies have very different definitions, which makes it difficult to speak the same language, exchange experiences and learn from one another.

This situation poses a twofold problem. On one hand, we have little information and even misconceptions of the informal economy, that make it difficult (even impossible) to design proper policies and programs. On the other hand, we have different MSEs definitions and views that difficult dialogue and reaching common policies and programs. So, we must advance in both directions: (i) creating a common ground within the MSE sector and from there, (ii) tackle the informal issue with coordination and renewed vitality.

To sum it up, the policy proposals (to be discussed by economy members) are:

- Support and promote MSE financing, both from commercial banks and microfinance institutions.
- Promote and strengthen the microfinance institutions when the size and characteristics of the informal sector requires it.
- Try to reach a common ground in the definitions, policies and programs both, for informal sector formalization and for MSEs promotion in the APEC economies.
- Coordinate, both within the economies and among them, between the MSE institutions and the ones dealing with the informal sector, in order to reach some common views of the informal sector and how to cope with it.
- Interchange experiences, best cases and policies in the formalization process of the informal MSEs.



## FINAL CONCLUSIONS

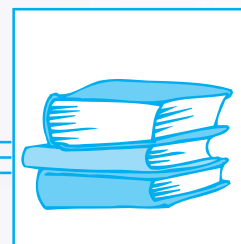
Ivan Mifflin ●

- Informal economy, unstructured economy, non-formal sector and underground economy are all synonyms of a single concept: informal economy. All these terms are referred to small enterprises that carry out activities in a diffuse frontier between formality and informality but without being illegal. Their activities have limited and reduced productivity with low costs and low entry barriers.
- Informality is a more critical issue for developing economies than for developed economies. In developed economies, this problem does not arise due to efficient systems for starting a business.
- Formalization has many advantages as the access to foreign markets, government procurement, to become part of the financial system and to be inserted in productive chains, which by definition require formality of the suppliers in the chain.
- The relationship between formality and informality has not got enough evidence although formality is a condition to access financing. However, the fundamental issue relies on the lack of competitiveness and productivity in all economic units, especially in MSEs.
- Micro finance industry is a powerful and globally extended industry. In APEC economies, as a response of the financial private sector to financial needs of MSEs, many experiences of microfinances have arisen. Nevertheless, the pending agenda includes not only granting credit and micro-credit but also accompanying the development of enterprises. This evidently diversifies financial services (leasing, venture capital, guarantee funds) and makes them more complex.
- Formality and financing are economic development issues that are related to competitiveness and productivity.

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# APPENDIXES

## Appendix 1: Summary of the Survey results

	INDONESIA	PHILIPPINES	CHINESE TAIPEI	CANADA	HONG KONG	JAPAN	BRUNEI DAUSSALAM	CHILE	MEXICO	AUSTRALIA	PERU	REPUBLIC OF KOREA
<b>General Statistics</b>												
Micro Enterprises												
Number of Employees	1-2	1-9	1-5	1-4	1-100		1-5	1-10 UP TO 71000	1-10	1-4	1-10 Up to 150,000	1-10 n/a
Sales		n/a		n/a			n/a	n/a	n/a	n/a	n/a	n/a
Amount of Assets (US\$)				n/a			n/a					n/a
Small Enterprises												
Number of Employees	3-10	10-99	1-20	5-99		43831	6-50	11-50 71 001- 742 000	11-100	5-19	1-50 Up to 850,000	Less than 300 n/a
Sales	112	n/a		n/a			n/a	n/a	n/a	n/a	n/a	n/a
Amount of Assets (US\$)				n/a			n/a					n/a
<b>Participation of Micro and Small Enterprises</b>												
GNP	46.06 E	30 E	10 E			11.6% (small)	n/a	12.9E	50 E	n/a	42.1%E	30%
Employment	99	60.8%	20%	62%	58%	29.3%	n/a	63%	70 E	47%	60%E	43%
Exports	4.16 E	25 E	n/a			14.5%	n/a	1.3%	5 E	1%	1.76	n/a
Enterprises	99.85%	99.3%	78%	99.3%	98%	87.9%	95.90%	96.9%	99%	96%	98%	89%
The information in "Doing Business" is correct for most economies	Yes	Yes	Yes					Yes	No	No	Yes	Yes
<b>Formalization</b>												
Informality is "The set of economic units that do not comply with government imposed-taxed and regulations."	Yes		Yes					Yes	Yes	Yes	Yes	Yes



Informality is a set of economic units with low productivity and income. Informality is a set of economic units involved in illegal activities (narcotics, counterfeit, and piracy, among others) Informality is considered a problem in our economy.	No	Yes	No	Yes	Yes	No	Yes	No	Yes	No	Yes	No	Yes	Yes	Yes	Yes	Yes		
The importance of informality in the Micro and Small enterprises sector																			
<i>Micro Enterprises</i>																			
% Number of firms	70	n/a	n/a	100%	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	30	67	n/a	n/a	@ 40%	
Employment	60	74	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	20 E	50	n/a	92.1% micro AND small 57%E of firms	n/a	@ 30%	
Other		44	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a			n/a				
<i>Small Enterprises</i>																			
% Number of firms	20	n/a	n/a	100%	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	5 E	n/a	n/a	@10%	
Employment	30	74	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	20 E	n/a	n/a	40%	@5%	
Other		44	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a							
<i>Finance Services for Micro and Small Enterprises</i>																			
Micro Enterprises																			
Commercial Banks provides financial services		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Microfinance Institutions	Yes	Yes	Yes	Yes	n/a	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	n/a	Yes
Venture Capital		Yes	Yes	Yes	n/a	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Other																			
<i>Small Enterprises</i>																			
Commercial Banks provides financial services	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Microfinance Institutions	Yes	Yes	Yes	Yes	n/a	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
Venture Capital		Yes	Yes	Yes	n/a	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	n/a	Yes
Other		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	n/a	Yes

Appendix 2:  
Costs of formalization in APEC economies

Starting a business in APEC\*

Economy	Number of procedures	Duration (Days)	Estimated Costs (US\$)
Australia	2	2	600.0
Canada	2	3	221.6
United States	5	5	210.0
Singapore	7	8	261.7
Hong Kong, China	5	11	824.8
New Zealand	2	12	39.3
Republic of Korea	12	22	2,239.2
Chile	9	27	509.4
Malaysia	9	30	965.8
Japan	11	31	3,981.3
Thailand	8	33	159.6
Russia	9	36	205.4
China	12	41	158.1
Chinese Taipei	8	48	820.0
Philippines	11	50	201.5
Papua New Guinea	8	56	181.5
Vietnam	11	56	136.1
México	8	58	959.0
Peru	10	98	793.1
Indonesia	12	151	1,163.3

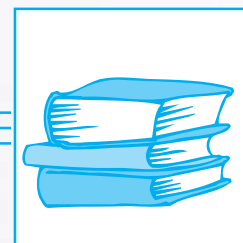
\*Source: Doing Business - World Bank (2004)



## ABBREVIATIONS

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- **ACC**  
APEC Center of Cooperation
- **APEC**  
Asia Pacific Economic Cooperation
- **CAF**  
Andean Corporation of Promotion
- **CMACs**  
Municipal Boxes of Saving and Credit
- **CODEMYPE**  
National Advice of Development of the Micro and Small Business
- **CRACs**  
Small Farm Loan Banks of Saving and Credit
- **EAP**  
Economically Active Population
- **FOGAPI**  
Foundation Bottom of Guarantee for Loans to the Small Industry
- **GDP**  
Gross Domestic Product
- **IFIS**  
Intermediary Financial Institutions

- **IFNB**  
Non Banking Financial Institutions
- **ILO**  
International Labor Organization
- **INDECOPI**  
National Institute for the Defense of the Competition and the Protection of the Intellectual Property.
- **MFI's**  
Micro Financial Institutions
- **MLEP**  
Ministry of Labor and Employment Promotion
- **MSE**  
Micro and Small Enterprises
- **PRODAME**  
Program of Self-employment and Microbusiness
- **PRONAFIM**  
National Program of Financing to the Micro Businesspeople
- **SME**  
Small and Medium Enterprise
- **SBS**  
Superintendence of Bank and Insurance
- **SUNAT**  
Superintendence of Fiscal Administration (Tax Authority)

