Entrenched informality

How non-enforcement, fintech, and digital payments are challenging development in Latin America

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In the late 1990s, José emigrated from Bolivia to Buenos Aires, Argentina. There, he found a formal job, which he lost in 2000. The following year, in 2001, José obtained 50 dollars and, using his mother's sewing machine, began informally manufacturing children's caps and selling them in La Salada, an informal garment-oriented marketplace located in a disadvantaged suburb of the Buenos Aires metropolitan area. Twenty-three years later, José is still producing and trading in this economy. He now has two production facilities, manufactures an average of 10,000 caps per month, and informally employs 16 people. José's case has two peculiarities. First, he works in an informal sector from beginning to end, from production to the final consumer. This means widespread lack of compliance with labor, safety, health, and fiscal standards. Such massive informality and the fact that this thriving informal economic sector has skyrocketed in the last 30 years calls for reflection on the role played by governments at different levels. The second peculiarity is that José, although he has many employees and produces thousands of garments per month, does not have a bank account. Instead, he manages the entire flow of payments and receipts through digital wallets like Mercado Pago. In other words, we are witnessing the expansion of informal businesses completely detached from formal processes, such as taxation or health, safety, and labor inspections. This digitization of the informal economy, particularly payments, calls for reflection on how these digital instruments are regulated, enforced, and implemented vis-à-vis public policies aimed at financial inclusion. In sum, the two salient features of José's business, otherwise a typical case of current informality in Latin America, point to the need to examine the main drivers of informality in the region.

Drawing on my ethnographic fieldwork in Argentina and Brazil, more than 115 in-depth interviews conducted in the last 10 years, and existing literature on the role of enforcement as a mechanism through which governments can achieve specific politically valuable objectives, this paper draws attention to the political economy around law enforcement. It analyzes how governments respond to the vast informal economy in which José works and poses questions on how governments respond to the expansion of fintech-based payment services. More specifically, this piece argues that non-enforcement can become an instrument through which governments implement what I called elsewhere an "informal industrial policy" (Dewey and Di Carlo 2022). For governments, non-enforcement can become an attractive strategy when a country's productive structure is such that non-enforcement of regulations can be deployed more effectively than alternative lawful industrial policies. Although this article focuses on informality in a specific economic sector – fast fashion – the argument can be extended to understand the rationale of the relationship between government and informality in other economic sectors.

The article is divided into four parts. First, I describe the primary explanations for labor informality in the region and show the importance of considering non-enforcement. Second, I present a succinct characterization of this informal economic sector in Argentina and Brazil. Third, starting from the observation that we are in the presence of economic sectors whose emergence is mainly due to government non-enforcement, I explain the political logic behind it. I conclude the article with reflections on what I regard as a crucial question for thinking about economic development in the region: the political economy of informality in Latin America, which means the study of the regulation of digital payment services, the non-enforcement of the law, and "financial inclusion" as public policy and discourse.

Drivers of informality in Latin America

Informality has been an enduring feature of the continent's labor markets for years, an almost "traditional" issue that is being renewed and given new contours by the pandemic and other concurrent processes, such as increasing digitalization. Debates on labor informality have traditionally been part of a broader discussion centered on the problem of how to foster economic development. Hence, the issue of informality is closely linked to questions about public policies, especially those directed at regulating labor markets, and the state's role in this process. As Tokman (2004) observed, discussions on the informal sector started as discussions on the labor market and the ample potential of informal activities for low-income sectors. Notably, the reflection on informality has not been primarily centered on illegal behavior but on its main drivers.

The first line of research on the causes of informality focused on labor markets and their capacity to generate new jobs (Tokman 2001; 1981; 1982; Ludmer 2019; Pinto 1970; Souza and Tokman 1976). This perspective presents informality as an alternative economic space to formal labor markets that cannot absorb workers, typically border or internal migrants moving to large urban centers. As noted by Tokman, one of the referents of this approach, the informal sector becomes a refuge, an easily accessible space for survival, where self-employment and microenterprises with unspecialized work processes flourish. In his view, informality reveals a segmented labor market that is characteristic of developing countries.

In the 1980s, with the expansion of work processes on a global scale and the recognition that informality was not a phenomenon specific to developing countries but rather to capitalist economies, scholars started observing informality in the context of the decentralization and specialization of work processes. Alejandro Portes (Portes and Schauffler 1993; Portes, Castells, and Benton 1991; Portes 1983), a clear representative of this perspective, proposed to see informality as a constitutive element of global capitalist dynamics, that is, as the consequence of companies that, in a context of growing international competitiveness and market instability, decentralize their production and flexibilize work processes. The latter means nothing less than a growing prominence of subcontracting, especially in developing countries, where the state's capacity to safeguard labor relations may be weak. Thus, the perspective introduced by Portes and colleagues (1991) no longer conceives of informality in terms of a mode of production or organization of work but instead emphasizes the modes of use of labor or, more specifically, the modes of contractual relations. According to Portes and his associates, statistics should consider the informality hidden in subcontracting chains composed of unprotected employees. This contribution to the debate was the initial impulse that would lead to changes in the definition of informality in the reports of the International Labour Organization.

In the mid-1980s, as a clear demonstration that reflection on labor informality in Latin America also implies reflection on the state's role, the economist Hernando de Soto (1990) proposed to understand the informal sector in terms of its possibilities for access to legality. Not without hope in the potential of those participating in the informal sector, de Soto suggested paying attention to the tangled web of regulations and bureaucratic processes that discourage entrepreneurship and creativity and hinder economic progress. Thus, regulatory simplification, the implementation of decentralization processes, and the dismantling of bureaucratic obstacles became the recipe by which a sector submerged in illegality could gain access to legality and realize its full potential.

By contributing to this long-standing debate on informality in Latin America, this article highlights an aspect that has not been considered in previous accounts: the enforcement of informality by governments. If there is one common feature of the above approaches to informality, it is that they assume governments have a clear interest in combating informality. Moreover, this supposed governmental interest manifests in regulatory proposals and changes to transform reality. At the risk of schematism, the aforementioned first line of research on informality, especially that centered around the Regional Employment Program for Latin America and the Caribbean (PREALC), emphasized the need for a variety of regulations aimed at combating informality, such as investment promotion, training, creation of microenterprises, or the recognition of rights. Similarly, the structuralist perspective of Portes and associates has focused on specific contractual arrangements, such as subcon-

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tracting by firms, and the need to increase the capacity of the state to monitor such labor relations. Finally, de Soto's neoliberal perspective, perhaps more explicitly, relies on regulations to simplify processes to combat informality. In sum, despite the idea that informality is a problem whose solution would lead to more robust and inclusive development in Latin America, the three approaches suggest regulatory changes to transform informality into something else but do not question the intention of the regulator to produce such changes.

These three approaches assume (1) that governments are interested in fighting informality through regulatory change and (2) that governments are, per se, interested in enforcing regulations. Based on this critical reading of the existing literature, my argument is that under certain circumstances, governments may not be interested in fighting informality but rather in promoting it, and they do so by not enforcing regulations. Current research on the non-enforcement of the law in Latin America can be divided into two main drivers of government behavior: electoral politics and the production of social order. The pioneering work of Lucas Ronconi (2010, 734; 2012) highlights the impact of the electoral cycle on enforcing labor standards. Later works such as that of Alisha Holland (2017) and others (Feierherd 2020; Brinks, Levitsky, and Murillo 2019) have given new impetus to the study of non-enforcement, now conceived as "forbearance" by emphasizing the distributional possibilities that non-enforcement offers. The second group of works (Dewey 2012; 2020; Dewey, Woll, and Ronconi 2021) does not ignore the role of electoral politics as a driving force of non-enforcement. However, it postulates that governments must also produce certain levels of social order to deploy a given political agenda. In other words, it is not so much elections as the social structure, which in the case of Latin America is characterized by high levels of structural informality, that imposes the non-enforcement agenda.

Taking the economies of La Salada and Feira da Madrugada as empirical references, the following sections develop the argument of non-enforcement driven by the need to produce social order. The latter is understood as the neutralization of protests or the avoidance of conflict, the creation of employment, even if informal, and the boosting of consumption. The economic sectors analyzed, devoted to the production and distribution of fast fashion, are characterized by a profound informality from production to final consumption, and both have grown exponentially in Latin America in the last 30 years. Non-enforcement is not a sufficient condition to explain the growth of this sector, but it is a necessary one. By focusing on the logic of governments facing structural problems and the need to produce governance, this article follows the tradition of works that reflect on the causes of informality and raise questions about the role of governments and state structures.

La Salada and Feira da Madrugada

La Salada in Buenos Aires and Feira da Madrugada in Sao Paulo are gigantic marketplaces devoted to the business of low-cost, sweatshop-made garments. On the one hand, these marketplaces nourish long-distance informal trade circuits that reach far-distant provinces and cities. On the other, they host thousands of garment entrepreneurs who rent a stall there to display and sell their products. Thus, La Salada and Feira da Madrugada work as meeting points between informal fast-fashion producers focused on wholesale and traders who travel to Buenos Aires or Sao Paulo to resell garments in other provinces. Both marketplaces are immense facilities that host thousands of stalls and facilitate the commercialization of essential clothing to a large part of Argentina and Brazil. Moreover, these marketplaces foster large informal economies in both countries. For example, around 200,000 people in Argentina work in the economy centered around La Salada, either in the production sector or distribution centers. None are correctly registered, implying they are excluded from access to contributory social security, including health insurance. Similar to what early conceptions of informality predicted, these economic sectors are virtually disconnected from formal processes from production to final consumption. In Feira da Madrugada and La Salada economies, production, distribution, and consumption occur outside state regulations.

The political economy logic of non-enforcement

The extension of these economies and the multiplicity of regulations that are evaded or violated call into question the role of governments at various levels. In the Latin American context, a common explanation of widespread law-breaking behaviors is the weakness of state institutions (Brinks, Levitsky, and Murillo 2020; 2019). However, the explanation of institutional weakness cannot be generalized to the case of La Salada and Feira da Madrugada since government responses in both cases are often consistent with the reactions of "strong states." Commonly, the lack of state capacity refers to structural constraints that, by their very nature, remain constant over time. However, rapid law enforcement responses, such as when scandals erupt over migrants exploited in sweatshops, suggest that governments do have the capacity to respond to specific events. As Acemoglu (2005) argues, the state capacity explanation often ignores the self-interested motivations of the actors in charge of law enforcement. In this sense, explanations of non-enforcement based on state capacity tend to treat state capacity as a fixed and exogenously produced quality. However, if we seriously consider the motivations of regulators, we should recognize that state weakness may be endogenous to the policy (Besley and Persson 2009), that is, governments' intention not to enforce the law by actively undermining state capacity. As recently noted, this undermining is a widespread phenomenon, mainly through the politicization of labor agencies, which weakens state capacity by limiting their ability to enforce labor standards (Dewey and Ronconi 2023).

Building on these critiques, several recent works analyze non-enforcement as a deliberate informal policy. Strategic non-enforcement by governments has been used to respond to increased competitive pressures generated by trade openness (Ronconi 2012a) or as a mechanism to extract resources from certain economic activities (Ceccagno 2017; Dewey 2018; 2020). This line of research has gained new momentum with Holland's (2017) work on forbearance. Here, politicians capture enforcement agencies and use non-enforcement to redistribute benefits, expecting to be rewarded by voters at election time. As stated before, without ignoring the explanatory potential of electoral competition as an incentive for non-enforcement, it is possible to extend Holland's explanation by highlighting it as an instrument to foster the economy.

In line with extant research, this article claims that the mentioned economies have grown in the heat of government non-enforcement. As I have argued elsewhere (Dewey and Di Carlo 2022), this non-enforcement can be seen as an informal mode of regulatory governance because governments shape the supply side in these economies through non-enforcement of regulatory violations. In other words, non-enforcement, implemented through the capture of state enforcement agencies and manipulating enforcement mechanisms, can become an informal industrial policy. Tinkering with enforcement mechanisms becomes particularly relevant in a context characterized by structural informality and import substitution-oriented government interventions that have lost their attractiveness.

In both economies, governments use the possibilities offered by non-enforcement as a strategic way of managing the economy. Through the manipulation of enforcement mechanisms – or what can be understood as "political leniency" (Holland 2016, 233) or a "reduction in the stringency" and effectiveness of enforcement mechanisms (Gordon and Hafer 2013, 209) – governments at different levels confer selective advantages to targeted socioeconomic groups that benefit over other, law-abiding market actors, such as formal garment producers. Various non-compliant actors, be they entrepreneurs, vendors, or traders, do not contribute to the state, thus enjoying higher incomes and the ability to pass on some of these savings in their final prices. The latter allows them to capture market share from formal competitors. Thus, non-enforcement in the informal sector is the functional equivalent of a direct subsidy used as an instrument of industrial policy.

This article posits two constellations in which governments may tinker with enforcement mechanisms. First, non-enforcement becomes an attractive policy choice when governments want to help thousands of garment entrepreneurs and traders scattered across the national territory but lack the legal competence to do so. For example, national governments have no jurisdiction over subnational matters such as labor inspections. However, they can influence enforcement agencies with national jurisdiction in crucial parts of the fast fashion distribution chain, such as police forces, to provide non-enforcement on the roads. Second, non-enforcement becomes an attractive instrument when the country's productive structure features structural informality, such that non-enforcement can be implemented more effectively than alternative legal industrial policies. As a result of non-enforcement of tax, safety, health, or labor enforcement in favor of certain groups, such as the participants in the two economies in question, those who do not comply with the law enjoy a de facto tolerated exemption vis-à-vis other actors who behave according to the law. Such tolerance is easily seen in the lack of inspection of the thousands of informal workshops that have proliferated in the last 30 years in both Buenos Aires and Sao Paulo.

Digital payment services: The new frontier of research on informality in Latin America

In recent years, and with particular impetus during and after the pandemic, digital infrastructures have profoundly changed the dynamics of the informal garment sector analyzed in this article. This observation is particularly true in the case of electronic payment methods. In the vein of de Soto's neoliberal credo, these services allow fast fashion producers and traders to carry out transactions in a "simplified" way. José, mentioned in the introduction, is a case in point. He has no accounts with traditional banking institutions. Instead, the universe of transactions directly or indirectly involved in producing ten thousand children's caps per month flow through 36 digital wallets, a service provided by the fintech companies Mercado Pago and Tarjeta Ualá.[1] These fintech-based digital payments have generated new dynamics in the informal sector and created contradictions with other public policies.

The informal economy is the space in which the conflicting relationship between two public policy orientations becomes evident: one that tends to "financially include" a sizable unbanked sector of the population and the other that seeks to prevent illegal transactions through digital payments. A clear expression of the first orientation is the promotion of digital wallets, which aim at financial inclusion according to the dominant discourse shared by both fintech and governments. That inclusion is achieved by reducing the barriers and friction to opening an account or making a transaction. For José and his employees, it is easier and less risky to rely on digital wallets to open accounts and carry out transactions than with traditional banking institutions. Meanwhile, an expression of the second orientation is the need and obligation of governments to prevent the proliferation of illegal transactions throughout the financial system. Traditionally, the latter has been achieved through a set of procedures and practices implemented by traditional banks and stemming from states' adherence to international anti-money laundering regulations.

In Latin America, these public policy orientations encounter points of conflict when the reduction of barriers and requirements for the use of fintech-based financial services (1) is exploited by illegal actors and (2) undermines the capacity of the state to monitor and control health, safety, and working conditions in informal economic enterprises that are far from marginal. In other words, governments face the dilemma of striking a balance between accessibility to financial services and the integrity of the financial system. In addition, successful cases like José's, which are common in the economies of La Salada and Feira da Madrugada, pose a fiscal problem in that they are businesses in which tax evasion is a massive phenomenon facilitated by digital wallets and accompanied by professionals (e.g., accountants, lawyers) who are aware of the lax regulation of digital payment services.

In political terms, this constellation can be analyzed by distinguishing between responsiveness and responsibility (Scharpf 1997). Governments are not only responsive to political groups, for example, by leaning toward greater inclusion of informal participants in the financial system at the expense of integrity for simple electoral motives. Governments are also responsible for maintaining a financial system that does not become a platform for various types of malpractice, collecting taxes, and promoting tax fairness.

Recent research on the link between digital platforms (Culpepper and Thelen 2020), their users, and governments shows that users generate a robust relationship with digital service companies, as the latter become essential tools that facilitate the fundamental dynamics of daily life. The power of platforms comes from the practical and emotional attachment of users to digital services. Any government action that upsets this relationship would mean a loss of political capital, as evidenced by the Argentine government's retraction every time Mercado Pago complains about regulations imposed by the Central Bank, such as the requirement for users to validate their identities or transactions (Chaves 2023). In the case of the economies analyzed in this article, digital wallets become an essential infrastructure on which the life of a business and all its employees depends. This alliance between users and technology companies significantly reduces the political incentives to impose restrictive regulations, such as collecting taxes or the obligation to declare the origin of funds. The pro-market orientation of several current Latin American governments and their unstable electoral bases allow us to predict a situation that confirms Culpepper and Thelen's thesis about the balance of power between government and platform. Future research should focus on the (non-)enforcement of anti-money laundering regulations aimed at not creating friction with the electorate of the informal economy.

Even assuming the political will to implement mechanisms to prevent illegal transactions and tax evasion exists, there are difficulties regarding state capacity. For example, interviews with agents of the Central Bank of Argentina indicate not only a problem of political will to control large companies such as Mercado Pago but also a problem of technical capacity and expertise to monitor millions of daily transactions and understand behavior patterns. In this context, it is important to highlight an obvious truth: digital media and digital payments are changing social practices. Knowledge of these new realities is essential for the state to effectively monitor economies such as La Salada or Feira da Madrugada. Behind a series of supposedly unrelated transactions seen by the state, José's case and many others reveal a scheme of interconnected actors whose goal is to use virtual wallets to evade taxes. In summary, new digital payment services are incorporating a segment of the population into the financial system and facilitating economic transactions, but the magnitude of this inclusion is at the same time potentially corrosive to the relationship between an economically disadvantaged segment of the population and governments that are expected to bring about change.

1 José, his wife, and their sixteen employees have two virtual wallets from Mercado Pago and Tarjeta Ualá.

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