Industrial Upgrading and the Administration of Labor Standards: An Approach to Formality, Informality and Poverty in an Open Economy

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Abstract:

This paper argues for the importance of the regulations and institutions that define the formal sector. It specifically takes issue with the neo-liberal approach which would reduce or eliminate the boundaries of the formal sector and argues instead for a policy designed to draw the firms and workers now outside those boundaries into compliance. The emphasis is upon forces from which conventional economic models abstract (for good scientific reasons), but which are critical to its efficiency, international competitiveness, and capacity for growth and development, and need to be recognized in designing public policy. Of particular concern is the way in which economic activity is socially embedded and the importance for technological development of the international economic and technical culture. It illustrates this argument by reference to the problems of traditional industries in Mexico in adjusting to the opening to trade and their inability to meet global standards of quality and reliability, using the furniture industry in the state of Michoacan as a concrete example. The paper then goes on to suggest a policy approach for addressing these problems, drawing upon ongoing research in labor market regulation in Mexico and the functioning of the Inspeccion de Trabajo.

* Note: I am indebted to a number of colleagues who have worked with me on these issues, but particularly to Clemente Ruiz Duran and Enrique Dussel Peters, with whom I worked on the adjustment of traditional industries to the opening to trade. My research on the administration of labor standards is supported by a grant from the Hewlett Foundation and by the assistance of Mara Hernandez. My colleagues and collaborators, however, do not necessarily share the view expressed here.
For almost twenty years now, the question of informality has been hostage to the neo-liberal discourse surrounding public policy. The background document which frames this conference represents a significant departure from those terms; it reorients the discussion toward active governmental policies designed to incorporate the designs of the informal sector into mainstream institutions. I hesitate at this point to return to the older frame of reference. Nonetheless, especially for an economist, that framework is analytically a useful, indeed almost an inevitable, point of departure. It constitutes a useful point of departure because the neo-liberal discourse is about the role of the state in the economy, and formality is defined by a set of regulatory and administrative structures which are, in the first instance, the product of state action. Given that fact, there are logically two distinct approaches that one can take toward informality. The liberal approach would suppress the state actions and activities which seem to create the distinction. I am not about to defend every rule and regulation that defines the boundaries of the informal sector and which this approach would eliminate. But I do intend to articulate a decidedly illiberal approach, one which would bring informal enterprises and workers under the umbrella of state policies and into compliance with its rules and regulations. My argument is essentially that, by and large, state policies in this regard are an expression of more fundamental forces governing economic activity, forces that the individual firm and the society as a whole ignore at their peril. Economic theory, upon which the neo-liberal perspective rests, abstracts from these forces. The abstractions create a powerful instrument of scientific analysis, but they also make it extremely hazardous to move directly from conclusions developed within that framework to public policy. To create responsible policy, one must take account of the forces that are left out. It is for these purposes critical to identify exactly what those forces are and how they affect the operation of the competitive market. Regulations that are not consistent with those forces need be amended or eliminated. Here, too, the economist’s model and mode of operation provides a disciplined way of thinking about the issues, but, again, it cannot be allowed to dictate the conclusion.

These are lessons that I have subscribed to for some time, long before I began to do research in Mexico. But they have been greatly reinforced by field work in Mexico and exposure to business and labor here over the last ten years. I want to try to use that
research here today to draw out their implications for public policy. Before turning to that research, a few additional remarks about the nature of the forces from which economic theory abstracts that are important in policies relating to the informal sector.

These forces involve, first and foremost, the fact that economic activity takes place in a social setting. Social settings invariably generate a set of normative standards; productive activity has to be organized in a way that is consistent with those standards if it is to operate effectively and efficiently. The social environment and the standards it generates are often depicted as static and traditional, and hence as a constraint on the flexibility which the competitive economic model seems to require. But in point of fact, the social environment is often in the process of evolution itself, an evolution which may or may not be consistent with the evolution of the economy. What drives the evolution of the economy, moreover, is a second factor from which the competitive model abstracts: technological change. Like the social environment, technology too is in perpetual evolution. The economic actors must somehow keep up with that evolution if they are to benefit from it. And the evolving technology must be reconciled with the social environment in which it is applied. That, in turn, requires a continued reinterpretation of the normative standards. All of this depends on processes that are as much political as economic, and which are certainly not modeled within the context of conventional economic theory.

To make this point concrete, I will draw upon two research projects in Mexico in which I have been directly involved. One is the impact of the opening of the economy to trade in a small furniture making center. The other is a study still in progress of the Inspeccion de Trabajo. The first illustrates the nature of the problem, the second points toward a solution.

**Traditional Industries in the Face of International Competition: Ciudad Hidalgo**

The major economic challenge in Mexico over the last decade has come from the opening to trade and the withdrawal of the government from the economy. These developments have placed enormous competitive pressure on small firms in mature industries such as clothing, shoes, furniture, and pottery. As labor-intensive, low-wage industries, they might have had a competitive advantage in the North American
marketplace created by NAFTA, but they were completely unprepared to cope with the new competitive environment. The principle problem is in the area of quality standards and reliability. Transnational buyers use statistical quality controls with which small producers were (and often remain) completely unfamiliar; they also expect an attention to the details of design and execution that are simply not part of the aesthetic of traditional producers. Often producers do not even see the defects in their products when the buyers point them out. One shop, for example, copied a clever design out of a mail order catalogue (a folding ironing board), and then improved it by making it more compact and adding a laundry basket; but the improved design required much more effort to open up than an American housewife would ever have tolerated. At the same time, the organization of transnational production changes and modern retailing demands scrupulous attention to delivery deadlines. They seek to minimize inventory, and to do so requires tight (even just-in-time) delivery schedules which small Mexican producers cannot meet. But these problems are symptomatic of the fact that there is a kind of international business and technical culture of which the small Mexican firms are not a part. That culture is in continual evolution. Thus, even were the excluded firms to be brought up to standards today with a team of consultants, they would quickly fall behind again.

These culturally isolated firms are excluded not only from global marketplace but increasingly from the domestic marketplace as well, as it is coming to be dominated by transnational retailers like Wal-Mart and Carrefour. Such large producers often find it easier to import even typically Mexican goods. When we began our study, we found a terracotta flower pot on a shelf in K-Mart in Mexico City which was imported from the New England Pottery Company, a half hour’s drive from my office at MIT. The net result of these factors is that many of these small firms have been driven out of business and their proprietors and employees into unemployment or forced to migrate to the States. Those that survive do so by driving down wages and working conditions in ways which violate not only international norms but their own normative standards. They sell in the informal sector, in tianguis and on the street, in a market which has probably actually been expanded by people like themselves who can no longer afford to shop in the formal sector. But since the technological advances in international retailing are
progressively driving down its prices, both the producers and the retailers of the informal sector are under continual pressure. The statistical categories hide these developments, especially in the garment industry, which has been repopulated by new firms, often with foreign ownership or working as subcontractors for foreign companies and typically employing a new labor force of young workers drawn out of rural areas (although many of these new firms are now under pressure from China).¹

I want to illustrate this process with an extended quotation from my case write-up of a particularly graphic example of the process I am describing that takes place in Ciudad Hidalgo, a small city in the mountains of the state of Michoacan. The major industry is woodworking, and I went there to visit furniture-making shops as part of a study we were conducting on the impact of the opening of the Mexican economy to trade upon traditional industries. The city had been hard hit by this process: There had once been over 3,000 furniture shops, but their numbers had declined rapidly in the early 1990’s, and by the time I was there in 1996 there were less than 1,000 left. As a labor economist, I was particularly interested in the prevailing labor standards in these shops, and adherence with labor regulations is the dimension of the rules and regulations defining the formal sector which I will particularly emphasize here.

The shops in Ciudad Hidalgo were in many ways typical of production in traditional industries such as clothing, shoes, ceramics and woodworking in Mexico and elsewhere in the developing world. They were attached to the living quarters of the proprietor, overflowing into what in other houses in the neighborhood would be the living room or the dining room or into outbuildings which would otherwise have served as a garage or to house farm animals. The work was laid out in a helter-skelter fashion, seemingly without order. And, of particular relevance to the debate about labor standards, there were children everywhere and of all ages. The older children helped with the work, fetching wood pieces on command for their parents, painting and varnishing, occasionally even cutting wood on electric saws, or at least learning how to do so. The younger children chased each other around the shops, jumping over open vats

¹ The impact of these new factories when they first open in Mexico and then when they subsequently leave to move elsewhere is a second story; it constitutes a whole separate chapter in the evolution of poverty and the informal sector in Mexico.
of glue and varnish; it was often hard to tell whether they were actually working or just playing games. In one shop, there were two babies sleeping on a pile of rags on the floor next to the table where their mothers worked sanding wood pieces.

Heath and safety was also a problem in these shops, certainly for the kids and often for the adults as well. The electrical saws were unguarded. The glue and varnish emitted toxic fumes; the material was probably poisonous if ingested and prolonged exposure carcinogenic (or at least I knew that this was the case in similar shops I had visited in Italy in the 1980’s).

But while the shops in Ciudad Hidalgo violated the rudimentary child labor norms and health and safety standards of advanced industrial economies right and left, they were not without a set of norms and standards of their own. Much of what was going on, in fact, was not child labor at all, but child care. The women who were working were also watching; they would stop work to nurse a baby when it awoke or mind the children if the games got out of hand. The line between play and work was fluid. As the children grew up, they were drawn progressively into the work process -- the line between work and play shifted gradually in a way that one could imagine more or less protected the health and safety of the kids and respected the limits of their physical and mental capacities. For the older kids whom we saw being taught to use the electrical equipment, the work was still something of a game. Imposing international standards upon these shops would have been in this sense a kind of cultural imperialism.

The shops of Ciudad Hidalgo were not, however, efficient; they were having real trouble competing in the international marketplace; and the blatant violation of international standards was not helping matters, indeed quite the contrary. In fact, we were following in the footsteps of a consultant who had been hired to help upgrade their operations and part of our mission was to evaluate his impact. The owners explained to us what was pretty evident to anyone familiar with modern production techniques, that the lay-out needed to be altered to smooth the flow of work, and the aisles cleared. They showed us, as the consultant had showed them, that the open vats of glue and varnish collected sawdust, which spoiled the finish on the wood. The children were a distraction which continually threatened the quality and the consistency of the work. Most of the changes the consultant had recommended to improve efficiency would clearly have
improved health and safety as well. One had to conclude that if the changes had been imposed by the enforcement of legal labor standards, however illiberal, they would have contributed to efficiency. Certainly, covering the barrels to protect them from the sawdust would have protected the workers from the noxious fumes and reduced the chances that the kids would ingest the poisonous material. Clearing passageways through the shop and isolating the equipment in well-defined work stations would have made it easy to install guard rails. But an efficient layout would also have repositioned the mothers into places where they could no longer see their babies or watch the older children. No amount of reorganization could completely eliminate the distraction of small children running around the shop. Ultimately, an efficient shop by western standards would have sent the children home.

None of these reforms were actually introduced in Ciudad Hidalgo. This was partly because the shops could not afford the continuing help of outside consultants that was required to upgrade their operations. But, more fundamentally, because the children were already home; they had nowhere else to go. Indeed, the child labor is basically one symptom of a more fundamental problem of these shops: The way in which productive activity is interwoven with, and inseparable from, the household. Thus, business and household finances were intermingled; the shop which, by common consensus, had the best designs and the most refined craftsmanship had been driven to the edge of bankruptcy when the head of the household fell sick and the working capital of the business was diverted to pay for his surgery. Others families lost their homes or their transportation when the businesses went broke. Infrastructure -- transport, water, sewage -- was inadequate because most of the shops were located in residential neighborhoods and interspersed with private dwellings. The shops were, in fact, a perfect illustration of one of Max Weber’s basic points about industrial capitalism: That its emergence requires the introduction -- indeed in early capitalism it required the invention -- of a distinction between the business and the household realms.

In late capitalism, at least in a country like the United States, it actually involves the creation of a third realm, a realm of education, which frees women from the responsibilities of childcare to enter the labor market. The conventional wisdom in
development policy is that prohibitions on child labor are only effective when accompanied by the expansion of the school system.

Unable to restructure their production process, the furniture shops in Ciudad Hidalgo were responding the pressures of the international marketplace unleashed by the opening to trade by cutting costs, reducing employment levels, intensifying the pace of work, and cutting wages. The result was to compromise prevailing standards and weaken protective structures. As the pace of work increased, people were distracted from watching the children; even when they remained committed to coming to their aid in a crisis, they were less likely to anticipate problems. Children who normally never would have been allowed to touch dangerous equipment unsupervised began to do so. As the amount of adult labor in the shop was reduced, children were drawn into production prematurely or prematurely assigned tasks inappropriate for their age. Thus, if the production system prior to trade could be said to respect its own set of standards, however it might have deviated from those of the industrial world, the impact of trade was to force them to violate not only international standards but also their own standards. They may have been better off materially than if they had failed to respond to the pressures of globalization at all – indeed, if that had happened they would have gone out of business. But they would have been much more competitive internationally, and better off materially as well, had they adopted a production system consistent with the labor standards embodied in the Mexican labor code, the code which defines and governs the formal sector.

The real question is not whether practices consistent with the labor code of the formal sector are more effective than those that Ciudad Hidalgo is adopting, but rather whether there is actually a third way, a set of practices which would enable Ciudad Hidalgo to compete in the international marketplace without mimicking the formal sector.

One such alternative, more compatible with traditional household production and the labor standards which grew up around it in Ciudad Hidalgo, is to move up-market into the production of customized items for specialty, niche markets. This strategy had been developed extensively by the industrial districts of central Italy in the 1970’s and almost a century earlier by the English districts described by Alfred Marshall. Marshall maintained that in the English districts people absorbed the craft skills and sense of the
materials from the very air they breathed, which is surely the experience of children growing up playing in the shops of Ciudad Hidalgo. This kind of production, of course, has exacting standards of quality as well, but they are very different from the quality standards of industrial production. The latter involve an emphasis on reliability and consistency: production to precise specifications, within a well-defined and limited margin of error. The standards of niche markets are much closer to the aesthetic of craftsmanship: novelty and an absolute standard of perfection. These standards are consistent with the leisurely pace of work and the informal organization of the Ciudad Hidalgo shops. Production for particular market niches would also require a considerable adjustment on the part of the producers of Ciudad Hidalgo, but one which would in many ways be easier for the true craftsmen among them to understand and appreciate than industrial standards, which focus on consistent production of medium quality goods and are often quite alien to the craft aesthetic. We actually encountered one furniture-maker in Michoacan (although not in Ciudad Hidalgo) who had quite successfully adopted a niche strategy of this kind. Also, the traditional industries of Jalisco have recently begun to systematically pursue an approach modeled on central Italy. This does seem to imply the revision of formal labor standards, but perhaps the creation of a special artisan sector. But, as we shall see in a minute, it might not: Mexico already has a legal and administrative structure which lends itself to such a policy.

The Inspeccion de Trabajo

That structure is exemplified by the Inspeccion de Trabajo, an agency which is the subject of a different research project in which I am presently engaged. The underlying nature of this structure and the approaches to public policy to which it lends itself have been obscured by recent comparisons with health and safety inspection in the U.S. and efforts to transfer policies and practices modeled on the U.S. to Mexico. But the Inspeccion de Trabajo actually derives from the institutional models of France and Spain, which are fundamentally different from that of the U.S. The basic difference is twofold: First, in the U.S., labor market regulations are administered by over a half dozen different agencies. One of these agencies, OSHA, has served as a template for administration reforms in Mexico, and its personnel have served as advisors to the
Federal Inspection Office. But in distinct contrast to the U.S., in the Latin system the whole of the labor code is administered by a single agency. The jurisdiction thus goes well beyond health and safety. The line officers of the inspection agency in the Latin system, when they visit an establishment, can in principle inspect for everything, from health and safety violations to violations of wage laws, union contracts, child labor laws, and even immigration laws. Among other things, this gives the line officers enormous discretion; since it is virtually impossible to examine every detail of the business operation over which they have jurisdiction, they must pick and choose what they are going to look at. This puts them in a position to weigh the cost to the enterprise and to the society of different regulations against each other and against the threat which they pose to the economic viability and survival of the enterprise. The second difference between the U.S. and the Latin system relates to the conception of the state and its relationship to the society. In the U.S. system, the state is essentially an enforcement apparatus: It is policing the labor market and/or the enterprise. In the Latin system, the state has the much broader mission of ensuring the health of the society. The inspectors, as representatives of the state, are trying to bring the enterprise into a broader harmony with the socio-economic system. Their goal is less to literally enforce the law than to use the law as an instrument in this larger purpose. When violations are found, the inspectors are empowered to work out a plan which identifies the underlying source of the violation and to implement remedies. Fines and penalties can be imposed, but they are not viewed as an end in themselves but rather as instruments in the pursuit of this broader objective. The enterprise cannot simply pay the fine in lieu of coming into compliance with the law. Of course, the underlying source of the violation may simply be the willingness of the entrepreneur to exploit the workers in any way he or she can, in which case the inspector is in effect a policeman involved in a quasi-criminal proceeding. But where the source of the problem lies, as it did in Ciudad Hidalgo, with the way in which the enterprise is organized and managed and the competitive pressures with which it is forced to cope, the inspector is in a position to function as a consultant or tutor, and the plan of compliance can be designed to reorganize the system of management and production. The inspectors are in a good position to help the enterprise develop such plans because their job puts
them into contact with a larger variety of enterprises and exposes them to a broader range of operational details than perhaps any other set of actors in the economy.

I am characterizing here the underlying model, a model which is closer to the actual system in operation in France or Spain than in Mexico (though even in Mexico much of what happens in practice is only understandable in these terms). The Inspeccion in Mexico has operated under several different administrative regimes over the past fifteen years, and, as I have said, the influence of the United States, both as a model and as a negotiating partner in the development of the NAFTA trading regime, has introduced elements into the Agency which are extraneous, and in some ways antagonistic, to the Latin model. But the role of the state envisaged by the PAN is very much in keeping with the original model and many of the reforms which have been introduced under the PAN administrations at the state and at the national levels have moved the Agency back in this direction. If these reforms were combined with an explicit attempt to diagnose the competitive problems of the informal sector and the kinds of changes in practice that they would need to adopt to meet the challenges they face, the inspectors could in fact play a central role in helping a city like Ciudad Hidalgo survive. They probably already have sufficient discretion to administer the law so that it is compatible with either of the two different adjustment patterns I have suggested; and they are, as I have also suggested, already playing the part of consultant or tutor, albeit most often without the guidance of a broader conception of economic development. A pilot program, which the Agency has introduced under the heading of “autogestion”, actually exempts certain enterprises from the normal inspection routine for a period of up to three years and places them under a regime designed to educate their personnel and upgrade their practices.

I do not mean to suggest that the Inspeccion de Trabajo could constitute by itself the vehicle for addressing the problems of the informal sector. For it to be an important part of that strategy would require an investment in training, strategic planning and an increase in the staff and compensation structure of the agency. But the approach which I am suggesting would combine well with the kind of economic development strategies for small businesses which have been pioneered at the state level by the PAN and which I have observed in operation, particularly in Guadalajara. The agencies administering those policies are in fact already engaged in the kinds of strategic research and planning
that would be required for the *Inspeccion de Trabajo* to play a developmental role, and they have a number of programs for upgrading enterprises that could be combined with programs, such as that of autogestion, already in place for upgrading labor conditions through education and training to make a package of different instruments.