Beyond The Informal Sector

Including the Excluded in Developing Countries

Edited By Jerry Jenkins

A SEQUOIA SEMINAR PUBLICATION

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Preface

The informal sectors of developing economies are perhaps the least studied or understood phenomena influencing the daily lives of people in the Third World. Development specialists, policymakers, businesses, and financial institutions are recognizing that their information on international economic development—as well as the well-being of an enormous number of the world's laborers—is severely limited by hidden, uncounted, and largely unknown economic forces. This volume addresses the difficulties involved in defining and assessing the characteristics of the informal sector. It also suggests methods of beginning to move beyond the divisions within and between the formal and informal sectors—a necessary step for achieving more equal opportunites for all.

This publication is the second in a series from seminars conducted by the Sequoia Institute. Addressing the topic *Including the Excluded: Extending the Benefits of Development*, the seminars facilitate the exchange of research, information, and ideas on issues critical to Third World development. The series examines the successes and failures of development strategies, encouraging the reexamination of established principles and, where necessary, the formulation of new ones. Additional volumes, also to be published by ICS Press, will focus on trade policies, capital markets, community, taxing, and other issues.

Robert B. Hawkins, Jr.
President and CEO
Institute for Contemporary Studies

San Francisco, California
September 1988

Foreword

This is the second publication resulting from a series of seminars introduced by Sequoia Institute in 1987. Expected to conclude in 1991, the series has two primary objectives:

a) to shed new light on critical issues of Third World development and its assistance, and

b) to serve as a catalyst for a new generation of thinkers and ideas that will accelerate the inclusion of *all* people in the process of individual and societal development.

The theme of the series, *INCLUDING THE EXCLUDED: Extending the Benefits of Development*, is more manifest in this book than in any other of the series. This is a natural consequence of the fact that the work of the Institute for Liberty and Democracy (ILD) in Lima, Peru, was a principal stimulus for this seminar/volume and was also in mind when the series theme was conceived. The benefits of Hernando de Soto's contributions to the October 22, 1987, seminar go substantially beyond the paper which ILD's founder prepared for launching the proceedings.

This volume complements that ensuing from the first seminar, five months earlier. Indeed, "The Informal Economy and Growth in LDCs" is in many respects the other face of its predecessor, "Policy Reform and Equity." That is, the accomplishment of policy reform and equity decreases the attraction of underground economies for people. Conversely, the expansion of informal economies is often a testament to the large number of people engaged in beneficial economic activities who are effectively excluded from participation in formal economies. Economies characterized by such exclusions are those most in need of reform.

Sponsorship of this series by the Agency for International Development (A.I.D.) is an outgrowth of the Agency's policy endeavors during the past several years. Support for these seminars continues a commitment by the Agency to encourage the reexamination of established precepts and practices pursuant to the formulation of more effective development policies. In accordance with this objective, the series strives to enlarge the supply of talent and ideas which are dedicated to development issues. One component of this effort, of course, is the publication and dissemination of each seminar's proceedings. Another is to bring together, within each of the seminars, several promising scholars who are relatively new to the international development field, by virtue of their youth or the concentration of their previous scholarship on other subject matter, for interacting with established development scholars and practitioners.

In addition to the Administrator of the Agency, Alan Woods, and Assistant Administrator, Richard E. Bissell, the support and cooperation of numerous A.I.D. personnel has been instrumental to the success of the seminar series. Within the Bureau for Program and Policy Coordination, the A.I.D. technical office most responsible for this endeavor, three project officers—Edwin L. Hullander, Warren Weinstein, and Neal S. Zank—have provided both encouragement and valuable technical assistance to the series since its inception.

The authors represented in this book join me in expressing appreciation to ICS Press and Roger Magyar, in particular, for their unstinting editorial efforts in bringing this manuscript to press.

Neither the Agency for International Development nor Sequoia Institute necessarily shares the opinions expressed in any of the series volumes. Nonetheless, it is hoped that the diversity of ideas and evidence found in these pages will stimulate the formulation of better ideas than otherwise would have occurred, and that a developing world will be the beneficiary.

Jerry Jenkins
Series Editor

Washington, D.C.
September 1988

1

Jerry Jenkins

Informal Economies: Emerging From Underground

A dramatic increase in attention to the informal sector has occurred during the past decade. Not coincidentally, "Recent studies indicate that in some developing countries the informal sector absorbs up to 70 percent of the urban labor force."[1] Although there is no consensus in defining it, this much is clear: the poor are disproportionately represented in any country's informal sector. Therefore, it is of natural interest to scholars and policymakers addressing issues of individual and societal development.

It is also apparent that the informal sector, regardless of definition, reflects divisions within countries that thwart economic growth and the development of their citizens. In exploring these divisions, the principal aim of this volume is to contribute positively to the peaceful incorporation of informal sectors within new, necessarily transformed, formal sectors of developing countries. The desirability of fulfilling this ambition does not require reference to the harassment so frequently accorded informals; it is amply illustrated by the relatively favorable environment of Kumasi, Ghana:

> Even though the Kumasi City Council took a positive view of the informal sector activities and allowed their operation in specific locations within the city, many of these enterprises were housed in temporary structures. . . . Nearly 80 percent . . . had access to neither water nor electricity. In some locations . . . though the city council owns the land and allows informal sector enterprises to continue on a token rent, building permanent structures is forbidden since the council plans to build permanent workshops eventually.[2]

It is not revealed whether the local government, obviously wanting permanent workshops to be built, had considered the possibility of sparing itself that expense by granting land titles to those occupants who would themselves build these structures. Clear, instead, are the disincentives for informals to invest in the physical facilities of even small industrial firms when the security (and value) of those fixed capital assets is inversely related to their visibility.

Because of this, it is not surprising that trade and service activities, rather than industrial enterprises, are preponderant in urban informal sectors.[3] Neither, for the same reason, is it surprising that informal sector industry (manufacturing and repair) may be more prevalent in developing countries' rural areas (towns of 20,000 or less) than in their urban centers.[4] Though the evidence for the latter is derived from a study of small-scale industries, over half of the small industrial firms in five of the seven countries surveyed were the one-person proprietorships that are invariably included in assessments of informal sectors. In addition, what the small-scale industry study says about its subject matter applies no less to that of the informal sector:

> Until relatively recently little has been known about small firms in most developing countries, particularly those enterprises at the lower end of the size spectrum. Most such firms elude the standard statistical nets and exist frequently unobserved in the underground economy. . . . government policymakers and donors have generally been forced, of necessity, to make decisions in this area "unencumbered by information."[5]

These firms are "often invisible, since much enterprise activity takes place within the farm compound and can be seen only by those who penetrate the privacy of the household."[6] In the course of penetrating that privacy, the study found that "official" censuses underestimate the number of small industrial firms by a factor of two to twenty.[7]

Of course, such privacy is dramatically reduced in more densely populated cities, and the likely number of small industrial firms further decreased by the responses of governments to the economic endeavors of those within the more visible informal sectors of cities. In spite of this, the total array of economic activities in the informal sectors of developing countries is preponderantly urban. This was vividly brought to light within the past 15 years, when the quandary yielded by numerous analyses of the Third World's employment problem was resolved by introducing underground economies into the equation.[8] The earlier analyses had shown burgeoning under-employment in cities, on the one hand, and escalating immigration to those same cities, on the other. This suggested that either the urban immigrants were incompetent or something else was not being taken into account. Realization that most of the immigrants were being engaged in informal economies not reflected in official employment statistics effectively eliminated the quandary while restoring competence to employment analyses.

In view of these "countability" problems, it is understandable that the governments of developing countries rely on point-of-sale taxes for their revenues to a far greater extent than do those of industrialized countries. This difference reflects the extent to which, in developing countries, income-producing activities are "missed" altogether by government accounts; the fact that most small proprietorships engage in predominantly cash transactions and do not keep written records; and the expense that would be required of government in order to more fully incorporate the informal sector in its income tax base (particularly relative to the additional revenue which such an effort would likely generate).

The extent to which the economic reality of a country's citizens is not counted, poorly estimated, or unknown by government, almost certainly contributes to inappropriate government policies and programs. This effect of informal sectors is both more general and fundamental than the *content* of a particular policy or program, be it labor policy that "misses" employment or tax policy that "misses" income. The magnitude of what is under-known to government—the magnitude of the informal sector—can induce a government to do what it otherwise might not, or not to do what it otherwise might. A government might resist deregulation of agricultural price controls, for example, on the grounds that the poor would be adversely affected by increased food prices. However, this decision might ignore the effects of extant price controls which

> often engender the creation of "unofficial" food markets where operations parallel those in the regulated sector. . . . if consumers have to purchase most of their food through parallel markets at higher than official prices, an increase in the official consumer price may have little bearing on their incomes.[9]

Lack of knowledge regarding the informal sector might affect the policy *realm* which a government assigns to itself—decisions about the role government should play in society—as well as the content of particular policies and programs.

Though there is some concern in industrialized countries for the adequacy of economic forecasts and policies due to underrepresentation of their underground economies,[10] the concern of their governments with informal sectors tends to focus on discerning criminal activities (ranging from outright tax evasion to the production and sale of illegal drugs). In contrast, studies of the informal sector in developing countries, with rare exception,[11] incorporate only the production and sale of goods and services that are legal to consume or utilize, but whose production and/or sale and/or consumption is frequently not registered with or by government authorities. Some of these economic activities may fail to meet one or more legal requirements, such as licensing of a business, attaining a permit for housing or industrial construction (perhaps the most frequent transgression),[12] payment of legal minimum wage to employees (probably the second most common deviation from legal prescription), sanitation, or other regulatory obligations; but whether they do or not is not a decisive criterion for their inclusion in most studies of developing countries' informal sectors.

There is little doubt that informal sector activities occupy far more of residents' time and far more of their total production in developing than in developed countries. There is also scant doubt that the full capacities of most individuals are unrealized in societies in which informal sectors are pervasive. If these assertions are accepted, the desirability of *transcending* the informal sector is apparent.

Each of the papers prepared for this volume argues that it is essential to address *more* than the informal sector in order to advance its incorporation into newly emergent economies possessing expanded capacity for accelerated and sustained growth. And, taken together, the papers provide information about the informal sector that is more useful to fulfilling the objective of economic growth for *all* individuals than do studies that confine themselves to the interior of the informal sector as they respectively define it. The reason for this judgment is illustrated in the next two sections, wherein the difficulty of focusing attention on something that goes by multiple names and appears to be several different things depending upon who is attempting to describe it is shown.

Too Many Names

During the past decade, scholars and policymakers have reached a considerable degree of consensus regarding the importance of the informal sector, even as its definition continues to be the subject of disagreement. This may account for why it is assigned so many different names. A short list (in addition to informal) includes underground, shadow, parallel, black market, second, off-the-books, submerged, and hidden. These names typically precede the word "economy," though the term "informal" is perhaps more frequently followed by the word "sector."

Rarely is a clear differentiation among these terms attempted; they are frequently, as in this volume, employed interchangeably. Indeed, what differentiation exists is less a product of differing analytic conceptions than of geography (in what part of the world the phenomenon is located):

> In West European countries like Spain off-the-books production and trade are called the "submerged" economy rather than "underground" as in the United States or "informal" as in Latin America. In Italy, the term of preference is "black labor," while in the Soviet Union and her satellites, "second economy" is the most popular.[13]

Insofar as these terms refer to the same thing, and any one of them is defined in such a way that its referents are clearly identified and differentiated from other phenomena, then this interchangeability of terms poses no problem and the names may be used as synonyms. Alternatively, if none of them is so defined, their interchangeability is essentially irrelevant for purposes of research and analysis. The latter alternative not only accurately characterizes the status of our knowledge, it is likely to remain that way.

This less than desirable status can be illustrated, therefore, by the multiple but divergent considerations of any one of the names ascribed to the phenomenon at issue. Because it is the most commonly used, appraisals of the "informal" economy (or sector) are employed in this book.

Too Many Things

In accordance with the conception of the first paper in this volume, by Hernando de Soto, the economic activities of participants in almost anyone's "informal sector" typically fail to fulfill one or another legal requirement, even as the objectives of their endeavors are perfectly lawful. They tend to violate at least one of formal government's licensing, minimum wage, tax, sanitation, reporting, or other requirements. Therefore, the small, mobile businesses most common in the informal sector are partly a consequence and partly a cause of their only partial legality.

Most assessments of countries' informal sectors find their composition, relative to the formal sectors, to be more labor- than capital-intensive; and/or more likely to employ traditional methods of production; and/or more likely to occupy temporary or mobile facilities; and/or smaller in size (of employees, physical facilities, and total production); and/or less likely to enjoy credit, either from formal lending institutions or in their transactions with other (formal or informal) businesses; and/or less likely to extend credit to their customers.

One of the earliest treatments of the phenomenon viewed wage employment, regardless of firm size (or number of employees) as a distinguishing characteristic of the *formal* sector.[14] Today, this distinction is highly uncommon, and the meaning of "informal sector" more amorphous, as suggested by the following assessment of the size of Indonesia's informal sector:

> A conservative estimate based on the 1980 population census suggests that over half the people engaged in non-agricultural activities—more than 12 million out of 23 million—were in the informal sector. This estimate includes all self-employed persons, temporary workers and family workers engaged in non-agricultural pursuits. It does not include very small enterprises with one or more regular wage employees, which are normally considered as belonging to the informal sector.[15]

Other studies rely almost exclusively upon the criterion of firm size for determining membership in the informal (formal) sector. Thus in responding to a request from the Government of The Gambia, an International Labor Organization (ILO) unit restricted its collection of data to establishments having fewer than five paid employees, "because in The Gambia all establishments engaging five or more paid employees are recorded in the formal sector."[16]

Additional criteria for distinguishing informal from formal economies are delineated in the following:

> Mazumdar and others at the World Bank have developed an approach to the informal/formal concept based on a dichotomy within the urban labor market. While wages and conditions of work in the for-

mal sector are "protected" by trade unions or governments or both, the participants in the informal sector are exposed to unmitigated market forces. Alternatively, the ILO has tended to identify the two sectors by the characteristics of the enterprises. Informal sector activities are characterized by ease of entry, small scale, and labor-intensive operations, where technology is adapted and skills are acquired outside of the formal school system and operate in highly competitive labor and product markets. On the other hand, the formal sector technology is imported and capital intensive and often involves foreign enterprises operating on a large scale in markets which have high barriers to entry. In general, the formal sector is enumerated by the government while the informal sector is ignored and often harassed and discouraged.[17]

The author of this assessment conducted a survey of informal sector enterprises in Nairobi, Kenya, that might yield information which would be deemed beneficial from either the World Bank or ILO perspective:

Enterprises were classified as belonging to the informal sector for the purpose of the survey if they operated out of a temporary physical structure. . . . [Those] in a concrete or cement block structure, were excluded from the sampling frame. Only activities operating in the open on waste ground, set up outside permanent structures, or operating from rough wooden structures, often with a roof made of cardboard, metal sheets, or polyethylene, were liable to be sampled.

Without becoming embroiled in the intractable debate about what constitutes the informal sector, we can certainly agree that such a collection of activities displays the essential characteristics of that economic subsystem featured by recent ILO and World Bank research.[18]

This compromise meant that the overwhelming majority of the sampled enterprises would be from the universe of informal sector enterprises addressed by both World Bank and ILO research. Indeed, these same entities would probably be contained in other samples that would have emerged from the application of most alternative conceptions of the informal sector to the same Nairobi universe.

It does not mean, however, that the majority of informal enterprises that would be identified by the ILO, World Bank, or others would share the characteristics of the firms in the Nairobi survey; it means only that the Nairobi firms would be *included* in the surveys by others.

Furthermore, and more important, even if it is assumed that the Nairobi sample "displays the essential characteristics of that economic subsystem featured by recent ILO and World Bank research," it does not follow from that fact alone that the most *common* attributes distinguishing informal from formal enterprises are the most *essential* to the most successful among them. One might expect the latter to be characterized by the *least* commonly shared attributes among informal enterprises, and to thereby be underrepresented or even excluded from empirical surveys based upon "samples" drawn in lieu of criteria for defining the sample universe. Thus might these surveys educate us as to their samples, but misinform with respect to the informal economy universe.

Given all this, it is understandable to find one of the three papers prepared for this volume (by Tyler Biggs, Merilee Grindle, and Donald Snodgrass) deeming the term "informal sector" to be a heuristic device at best; another (by Janet Landa) focusing on a distinct subset of the informal sector, referring to it as the "shadow economy"; and the third (by Hernando de Soto) eschewing any attributes of firms in his identification of participants in informal economies in favor of a single criterion: their failure to fulfill one or more of the legal requirements for participation in the formal economy.

Elsewhere, it has been suggested that the informal sector be defined "as that in which the return to labor . . . is determined by the forces of supply and demand."[19] By implication, the formal sector must be defined as that in which the return to labor is determined by other forces. The nature of these other forces is delineated in the following section, and is seen as stimuli which simultaneously discourage a market economy within the formal sector and encourage the growth of the informal sector by reinforcing the structure of official decision making in the formal sector.

Transaction Costs and Informal Sectors

Informal sectors, their underground economies, and poverty, itself, are sometimes attributed to "market failures."[20] But, as Kenneth Arrow has observed, "it is better to consider a broader category, that of transaction costs, which in general impede and in particular cases completely block the formation of markets."[21] Such environments are far more demanding of those who would practice the "business of business" than is the case in developed Western economies; yet they seem to typify the economics within formal sectors and between sectors in most developing countries. This judgment is illustrated by Bauer's characterization of "disastrous politicization in the Third World":

> When social and economic life is extensively politicized. . . . People divert their resources and attention from productive economic activity into other arenas, such as trying to forecast political developments, placating or bribing politicians and civil servants, operating or evading controls. They are induced or even forced into these activities in order either to protect themselves from the all important decisions of the rulers or, where possible, to benefit from them. This direction of people's activities and resources must damage the economic performance and development of a society, since these depend critically on the deployment of people's human, financial and physical resources.[22]

There is an additional layer of transaction costs which must be incurred by those who would succeed in the formal economies of these societies. Of course, in the process of doing what they must to succeed, they reinforce the very structure which imposes those costs, further impeding the operation and even the development of markets. In highly politicized societies, those commonly referred to as "capitalists" are more accurately "mercantilists." Their principal aim is to promote their own protection. Mercantilists were attacked by both Karl Marx and Adam Smith. Marx called them "capitalists," and thus were the seeds of much misunderstanding sown.

Mercantilists are the penultimate rent-seekers; seeking additional income in lieu of commensurate increases in their productivity. If they are entrepreneurs, it is within the polity to the neglect of the economy. In highly politicized societies, getting ahead economically requires getting ahead politically. Thus do economic elites utilize political authority to the relative disadvantage of erstwhile competitors, and political elites "legislate" or "regulate" the economic success of themselves and their associates. In the process of benefiting themselves, participants in the formal sector's official decision-making structure effectively exclude others (majorities) from enjoying the opportunities which they require for themselves.

Highly politicized societies are characterized by the merger of authoritative decision making of both polity and economy, and spawn substantial legal and other obstacles to both access and sustained participation in a country's formal sector. It is in this context that the frequent assessments of the "lack of entrepreneurial talent" in developing countries are most appropriately evaluated. When such talent is not readily evident, it may well be a function of the milieu in which individuals live, in which case it is a grave mistake to confuse observed entrepreneurial *behavior* with the ability or *talent* for such behavior.

The concluding paper in this volume, by Tyler Biggs, Merilee Grindle, and Donald Snodgrass, embodies a clear expectation that entrepreneurial talent—whether classified as residing within an informal sector or not—exceeds that which is readily observable in developing countries. They expect that talent to become fully manifested in developing countries only with the cessation of government interventions that distort the operation of a market economy and the implementation of economic policies that reward the performance rather than privilege of their citizens. These expectations are abundantly supported by the exposition of entrepreneurial *behavior* within the informal sector that is provided by the other two papers prepared for this volume.

Indeed, Hernando de Soto's paper not only provides substantial evidence of entrepreneurial behavior in Peru's informal sector, but explicitly links the existence and growth of that sector with what he terms the "mercantilist" structure of official decision making.

His description suggests that, in Peru, political entrepreneurs are pre-eminent in the formal sector, and economic entrepreneurs in the informal, in accordance with the behavior induced by the differing incentive structures of the two sectors.

Whether or not the government policies which distort the "market" of the formal sector economy (as in Biggs, Grindle, and Snodgrass) are a natural consequence of a highly politicized society (as in de Soto) is a fundamentally important question. But regardless of its answer, those policies raise the transaction costs of participation in the formal sector economy. In most developing countries, it appears that the transaction costs relative to benefits required for sustained participation in the formal sector may exceed those of the informal sector, thus discouraging entry from, and encouraging exit to, the informal sector.[23] An apparent behavioral preference for participation in the informal sector should not, however, be viewed as reflecting a desire for informality. There is too much evidence of the desire to reduce transaction costs by the creation of formality *within* informal sectors.

Emergent Economies in Informal Sectors

The papers by Janet Landa and Hernando de Soto suggest that successful formal sector entrepreneurs, placed in an environment where property rights and contractual obligations are highly uncertain—where their economic activities are hindered to a greater extent than they are facilitated by the law of formal government(s)—will not succeed unless they are more than economic entrepreneurs. Where the formal sector is both a contributor and product of a highly politicized society (the official decision-making structure may be mercantile, as de Soto describes it), they must also be political entrepreneurs; in the informal sector, they must provide for themselves as much as they can of the institutional elements of markets—a public good whose provision by government is so long-standing and ubiquitous in developed Western economies that their entrepreneurs take it for granted. Drawing upon documentation compiled by researchers with the Institute for Liberty and Democracy (ILD, founded by de Soto), Claudia Rosett has noted evidence of extragovernmental provision of market institutions in Lima's informal sector:

> An underground legal code has developed that ignores the inefficient laws that drive people into the underground in the first place. This code is so powerful and pervasive that underground businessmen can dependably make deals with each other and the legal sector that could never be enforced in a government court. In Lima, for example, street vendors command prices of up to $750 for sale of their business locations, although they hold no legal titles to the spots.

Furthermore,

> informal contractors sometimes hire off-duty judges to arbitrate disputes. While some of these judges take bribes when working for the state, they cannot afford to do so when working for the underground. If word gets out that they are crooked, they will not be hired again.[24]

More generally, Janet Landa's paper suggests that the most economically successful individuals in informal sectors can be identified with emergent economies in those sectors, and that their most common distinguishing feature is the extent to which they provide law for themselves that is not otherwise available.

However, both de Soto and Landa emphasize that the increased predictability and reduced transaction costs from the provision of such private law—no matter how much it contributes to the relative success of the providers within the informal sector—is a poor surrogate for the impersonal law of property, contracts, torts, etc., that is publicly and impartially provided, adjudicated, and enforced.

De Soto reports in his paper that investment values were found to experience a ninefold increase once occupants gained formal title to their land, and Landa finds such provision of private law among informals in space and time only among ethnic minorities, or ethnically homogeneous middleman groups (EHMGs) such as the Indians expelled from Uganda by Idi Amin.

Nonetheless, Landa's paper suggests that looking for informal economies only where mercantilism prevails would understate their universality. Her paper provides abundant evidence that the *omissions* of governments—for example, the failure to provide what de Soto terms "facilitative law" (impartially adjudicated contract, property, and torts law)—are sufficient for inducing the emergence of what she terms "shadow economies," comprising those individuals within the informal sector who fill this void for themselves in order to reduce the transaction costs that thwart economic success.

The most successful participants in informal economies share with other informals relative independence from the obligations and benefits of formal facilitative law. But, in contrast with other informals, they have formalized their informal status by establishing, for and among themselves, at least some of the institutional elements of facilitative law. In a phrase, they are the "formal informals." Their characteristics are decidedly *not* those most *commonly* reported (as discussed in the second section of this introduction) in part because they are not the most easily observed, but also because they might be assumed to be "formal" by the attributes-of-firms criteria that are typically employed in analyses of informal sectors.

The evidence of private law provided by de Soto and Landa indicates that "formalization" may account for economic success *within* the informal sector quite as much as between the formal and informal. More fundamentally, facilitative law is obviously valued by informals. Thus, their extralegality is not a rejection of formal law, per se, but a result of its absence, and/or content, and/or accessibility in the formal sector. An implication of this is that institutional changes in formal sectors might attract entry or re-entry of individuals from informal economies into the new formal sectors. Again, this is the ultimate objective to which this book aspires to contribute. The *difficulties* of getting there are addressed throughout this volume. Fortunately, it also provides ideas for overcoming these obstacles. The book's concluding pages are dedicated to expanding upon these ideas in striving to specify the means by which the growth-retarding divisions within and between informal and formal sectors might be transcended.

2

Hernando de Soto

Constraints on People: The Origins of Underground Economies and Limits to Their Growth

The Instituto Libertad y Democracia (ILD) has stimulated new perceptions and understandings of the causes of Latin American underdevelopment through its study of the informal sector (composed of those people who, although pursuing legal ends, such as building a house or operating a business, have not met all of the legal requirements to do so).

The publication of the book setting forth ILD's thesis, *El Otro Sendero* (The other path), has sparked unprecedented interest throughout Latin America. It has been widely recognized as representing a new trend in Latin America—a non-Marxist, non-*dependencista* and anti-oligarchic alternative.

It has sold over 70,000 copies in the five countries in which it has been distributed since November 1986. It has broken all sales records in Peru, where the sixth edition has just come out. It is a best seller in Colombia, Ecuador, and Venezuela and is presently number two in Mexico. Over 800 articles on the book have been published around the world including, in addition to Latin America, the United States, France, Italy, Germany, and Spain. The book was launched in Mexico with an eight-hour TV discussion and documentary on informal economies. It is forthcoming in Argentina for the Southern Cone countries, and in Brazil where it has been translated into Portuguese. Translation into English has been completed; translation into German and French is underway.

It has been lauded by the Secretary General of the United Nations, called the greatest challenge to Marxist thought in recent years, and supported by hundreds of thousands of informals in meetings and published statements. Everywhere the book has been launched, ILD has been contacted by leaders of all the major political parties to express interest in learning how to apply its lessons. And the 21st Ordinary Assembly of the Latin American Episcopal Council (CELAM), which coordinates the activities of the Latin American Bishops, held in Asuncion, Paraguay, in March 1987 picked up and used an explicit message from *El Otro Sendero*: "The poor must not be confused with the proletariat . . . an option for the poor does not mean an option for class confrontation."

The ILD's conclusion is that the problem of Peru and, by implication, much of Latin America is that it lacks the legal institutions required for broad-based economic development to take place and for participatory democracy to function. This conclusion is based on empirical evidence gained from an in-depth study of the informal sector, which now represents more than half of the population of Peru and produces 38 percent of its GDP.

Informality is a symptom of institutional dysfunction because it indicates that much of the law has lost its legitimacy. Our research reveals that, because of the labyrinth of rules and regulations, it is virtually impossible for poor people to comply with all of the requirements to live and work legally. And, even for those who are able to do so, the costs of remaining legal are overwhelming. The result is that the productivity of the whole country is lowered dramatically.

The ILD posits that the study of informality and its causes holds the key to development in Latin America for several reasons. First, it enables one to identify the sources of institutional inefficiency by examining which institutions the informals have opted out of. Second, by studying the extralegal norms spontaneously created by the informals as a substitute for the law, one can recognize what the informals are voting for with their feet. Third, our research reveals that the extralegal institutions adopted by the informals are eminently democratic, and the economic system they have devised is a nondiscriminatory market economy. Therefore, the informals are the largest, as-yet-unrecognized, totally nationalistic constituency on the continent for participatory democracy and a market-driven economy.

Our research indicates that Latin American law discourages entrepreneurship and does not allow for popular participation in government. This suggests a parallel between Latin America today and European mercantilism of the fifteenth to the nineteenth centuries, which was attacked by both Adam Smith and Karl Marx. This mercantilism decayed or was violently overthrown and replaced, eventually, by the modern democracies of the West or the Communist regimes of the East.

Mercantilism centralizes economic and political decision making in a small elite. In Latin America today, whether their ideology is of the right or left, civilian or military, the elites rule in the same way—through closed, special interest legislation. For example, in Peru an average of 99 percent of all rules and regulations are passed without public consultation—or often, even knowledge. And this figure does not differ significantly no matter who is in power. Moreover, there is no public accountability. Thus, though there may be elections, most of the basic institutions required for a participatory democracy—government by the people—simply do not exist.

In Europe both Western and Eastern systems managed, in different ways, to resolve the contradictions of mercantilism. But while the transition from mercantilism to communism is well-documented, easily understood, and politically well organized, the same is not true of the transition to participatory Western democracy. Transition in the West took place in an unconscious and spontaneous way. Legal institutions were modified in an ad hoc manner and gradually resolved many of the contradictions inherent in early European capitalism.

The ILD believes it has begun to discover deliberate ways by which to make the peaceful transition to democracy and widespread entrepreneurship by studying informality, the deficiencies of existing Latin mercantilist institutions, the institutional history of the West and its present day legal systems. These ways are totally compatible with the competitive economies and open characteristics of Western style democracies and are overwhelmingly supported by the Latin American majority—the informals.

The foregoing means that blind support for many of the prevailing systems in Latin America is a mistake for they are not the open democracies and economies of the West but, rather, the mercantilist predecessors of both the Western and Communist systems. Support for mercantilism seems doomed to failure because today it is being massively disobeyed by the informals and rightfully challenged by the Communists. It is, therefore, crucial to end this tragic confusion and to clearly distinguish between mercantilism and modern systems. The answer, the ILD maintains, lies in adopting those legal institutions which make democracy and markets work for everyone and whose roots are found among Latin informals and Western nations.

The support the ILD has received from informals each time it has publicly proposed changes in the legal institutions indicates that the informals can be a spearhead for reform. For example, representation by almost 500,000 informals was received in support of the ILD's legislative proposals on property titling and adjudication. On publication of *El Otro Sendero*, 300,000 informal transport drivers published an ad requesting the ILD's help in defense of their cause and in developing a private, market-based transport system in Peru. And, so far, over 2,700 articles have appeared in the Peruvian press on ILD concepts and activities, demonstrating a widespread interest in the role informals can play in change.

The direction change needs to take if participatory democracy and markets accessible to the poor are to be achieved peacefully falls into four basic categories:

- opening up economic participation;
- creation of institutions to decentralize and deregulate government power;
- creation of institutions to control and make accountable the monopolistic exercise of government power;
- public education to mobilize support for change.

In less than four years the ILD has gone from pursuit of a troubling question—why does informality exist—to identification of its sources, laying out the direction for reform, demonstration of popular support for measures that complement this direction, and having an impact on legislation. To move from this point of accomplishment to the implementation of more substantial and fundamental reform, however, a long-term program is required.

Results of the ILD's Activities

First Finding: Entrepreneurial Energy of Popular Origin. An important part of the ILD's resources has been dedicated to developing effective methods for identifying and quantifying informal activities. As a result, the existence of enormous entrepreneurial energy in the popular classes of the country has been revealed. After several years of research we discovered that, in aggregate terms, 38.9 percent of the 1984 gross domestic product was produced informally and that 61.2 percent of all man-hours in Peru were worked informally.

In addition, it was learned that official statistics underestimated the amount of informality existing in many economic sectors. Housing provides a good example. When the ILD began its research, official statistics indicated that only 14 percent of the housing in Lima was informal; nevertheless, our work demonstrated that informal housing actually makes up 42.6 percent of all housing in the capital, sheltering 47 percent of the population. Through a house by house measurement, informal housing construction over the last 20 years was valued at $8.3 billion, all generated by the popular classes. In this same period of time, the government constructed popular housing worth $174 million—which is to say, only 2.1 percent of that generated by the informals.

Another economic sector in which good evidence was found is commerce. Through field work and two censuses conducted in 1985 and 1986 it was established, in the first place, that there are 91,455 street vendors in the capital representing 42.2 percent of labor involved in commerce, distributing approximately 60 percent of the food in the city and earning an income almost 40 percent greater than the minimum income allotted by the government.

A second stage of the research found that entrepreneurial energy in this sector is not limited to street commerce but that the street vendors themselves have begun an enormous effort to leave the streets for markets and commercial centers specially constructed for this purpose. In all, former street vendors have put up 274 markets and commercial centers, worth $40.9 million and employing 40,000 individuals. This compares very favorably with the state effort: over the last 20 years, for each market put up by the state, informals put up 12, including the largest market in Lima equipped with cold storage chambers, parking lots and most conveniences found in modern-day installations.

In the case of transport, findings of equal import were made. It was discovered that the informals provide 93 percent of the mass transportation fleet and 80 percent of seating space. This fleet has a replacement value of $620 million to which must be added $400 million invested in repair garages, spare parts, service stations and other infrastructure. If one adds taxis as well, the informal presence in public transportation rises to 95 percent. The average fare on an informal bus is 10 cents while in many Western cities it approaches $1.50 including a state subsidy.

Finally, in spite of the fact that informal industry is the most difficult sector to quantify because it operates "underground," the methodology used has revealed meaningful information. Among it, that informality covers areas as broad as mining equipment, bicycles, preserved meat, and fruits, and that it accounts for at least 60 percent of the production of garments and furniture and some 35 percent of textile production. The ILD's estimates indicate that informal industries compose 52 percent of industrial production establishments, employ 34.2 percent of industrial workers, and generate 18 percent of the value added in the whole sector.

Second Finding: An Inoperative Legal System. As a result of its findings about the extent of informality in the economy, the ILD asked why all of this entrepreneurial energy was channeled informally. Why not obey and be protected by the law? We discovered, through simulations and document studies, that numerous obstacles of legal origin constrain the development of these activities. As a result, a large percentage of the population, particularly those of limited income, are excluded from legality and deprived of the facilities it offers. In effect, it was determined that the lack of legality has very costly consequences for the informals because it deprives them of the facilitative aspects of the law—property rights, contracts and torts—which are indispensable for growth. Finally, it became apparent that the principal cause of these problems is the existing political system which the ILD denominated "mercantilist." We will deal with each of these findings separately.

The Obstacles. Obstacles occur at two levels: in access to formal economic activities and in remaining in them. The ILD demonstrated that, in order to operate legally, people have to meet a series of costs imposed by the state under different regulations. For example, in the case of housing, the major portion of the population does not have the resources to buy a piece of developed land in a residential zone. Thus, their only legal alternative is to request government adjudication of an undeveloped plot of desert land—which is one of the most abundant resources of the country. However, the ILD found, by following the trail of actual documents, that the procedures for adjudicating undeveloped state land actually take a minimum of 56 months of effort and the completion of 207 administrative steps, involving 48 public offices. The cost per family, not counting the purchase value of the land, is $2,156, the equivalent of four years and eight months income for a person who earns the minimum wage. To this must be added 27 months of red tape to obtain the license to develop the land and build on it. All of the steps required to legally obtain a piece of undeveloped land on which to build take, on average, seven years.

As a result of such obstacles, invading land has become the only recourse of the poor for gaining access to housing. The discrepancy between the human need for housing and the formal system of access to it is clearly demonstrated by the following. During 1985 in Lima, according to police statistics, there have been 282 invasions of public and private land giving rise to a similar number of housing settlements. Meanwhile, in this same period of time, there were only three legal adjudications of land. These invasions are organized and generally involve from 10 to 40,000 people. Most invaders of public land will eventually be recognized by the state, but to get legal title to their plots the settlers will have to comply with red tape that takes an average of 20 years to satisfy. Until they obtain title, their status is informal.

There is a striking contradiction in this situation. Because the Marxists have led the principal political groups providing organizational support to the invaders, it is they who have benefited from the desire for private property. Thus, the lack of legal access to private property has pushed the neediest classes toward radical professional politicians and, in some cases, close contact with subversive elements.

With regard to commerce, the ILD has calculated that street vendors, due to their informality, have to wait an average of 12 years from the moment they decide to construct their markets or commercial centers until they can begin to do so. Of this time, nine years and eight months are required for complying with bureaucratic steps and the rest of the time is taken in organizing themselves informally as entrepreneurs. It takes this long because they do not have access to adequate legal forms of business organization.

The case of transport is even more dramatic. The state simply does not permit legal access. It only sporadically allows those who have already invaded transport routes to receive formal recognition. If legal access were permitted, our best estimate is that compliance with red tape would take three years.

Finally, in industry, the ILD conducted a complete simulation of the legal process that must be followed to legally register and commence production. This was done by installing a small garment factory, with two sewing machines, in an industrial site on the outskirts of Lima. Four university students and one administrative lawyer completed all of the legal requirements, going from office to office soliciting the different, required permits and licenses. They kept careful records of the time spent and, afterwards, diagrammed the results on a "PERT" chart. Working six hours a day, it took 289 days to complete the red tape requirements. Ten times they were asked for bribes and were forced to pay them on two occasions in order to proceed. In terms of foregone income and expenses incurred, the 289 days are equivalent to a cost of $1,231; 32 times the minimum wage established by the state.

Legal obstacles not only limit access to sectorial activities, but also to factor markets. One dramatic example is access to capital. Eighty-five percent of all credit in the financial system is offered by institutions partially or totally controlled by the state. Yet the informal sector receives only 0.2 percent of credit in the official system and must resort to costly and difficult informal sources. Meanwhile, many in the formal sector legally receive subsidized credit which, of course, comes at the expense of savings. Thus, no real credit market exists, but rather there is a politically controlled segmentation of available credit based on influence. As a result, the possibilities for economic expansion and social progress by the most needy classes are stunted.

A similar situation exists with regard to the external debt. The oppressive weight of the debt is the direct result of an institutional structure that permitted government and state-owned companies to contract large loans and projects from foreign banks and contractors. Now that the debt has become too heavy to be supported by these entities, the rest of Peru has to pay the price, be it through the government's limitation on repayment—thereby avoiding new capital investments in the country—or through beginning to pay the debt—thereby draining away funds that could otherwise be invested in activities to promote growth.

The ILD's empirical research has proved that legal obstacles also exist for those who function formally, increasing their costs of operating. The ILD evaluated the costs of remaining legal by interviewing 50 small, formal firms of 1 to 14 employees each. These entrepreneurs, it was established, retain only 23.3 percent of their gross profits. The other 76.7 percent goes to the government. Of this, only 22.9 percent is paid in the form of taxes. The rest is spent on bureaucratic red tape or in meeting government mandated social benefits. In this sense, the informals have a better regime; on average, they only pay 15 percent of gross income in the form of bribes to government officials.

The Lack of Facilitative Law. The expense of entering the formal sector and remaining there forces most Peruvians to operate outside the law. This means that informals cannot take advantage of the facilitative aspects of the law, principally property rights, security of contracts, and torts. As the ILD has discovered, this has enormous implications for development. Indeed, how much investment would have taken place in the Western world without well-defined and secure property rights and court systems to protect them? How many inventions would there have been without patents or royalties? How many long-term investment projects would have been begun without secure contracts? How many risks would have been taken if there were no limited liability or insurance policies? Or how much capital could have been pooled without limited liability companies and shareholder systems? How many times could one have failed and then started again if debts could not be converted into shares? And how many companies could have prospered and grown over time if there were no perpetual succession? Could industrialization have taken place without economies of scale? Yet, the informals lack all of these facilities because they are on the margin of the law. Given the importance of these facilitative aspects of the law, it is worthwhile considering them separately.

Property Rights. Property rights serve a fundamental economic function; the assignment of resources. Without well-defined property rights, all activity and interchange is difficult. When neither exclusivity nor the right to transfer resources exists, the means for determining relative values and for maximizing economic benefits are lacking. On the other hand, the more secure are property rights, the less costly will be transactions, and the greater will be the interest in discovering and taking advantage of existing economic opportunities.

Thus, the function of property rights is to encourage those who hold them to add value to them by innovating, investing, or combining them productively. All of our empirical research regarding property demonstrates incontrovertibly that the lack of secure property rights enormously reduces the productivity of the majority of Peruvians. Not having legal recognition of their possessions causes people in informal settlements to limit their investment in them. Through a sample of 38 settlements, it was determined that, on average, the value of their investment increased 9 times once people had title to their land.

Contracts. To interchange goods freely is also crucial to development. To do so, the law must provide for security of contracts. In this regard, courts and judges to ensure enforcement are critical.

Nevertheless, informals, precisely because of their informality, do not have such security. As a result, they cannot make long-term contracts, or finance themselves through enforceable guarantees. They have no protection in the face of broken promises. They cannot obtain insurance to reduce their risks.

Contracts also allow resources from different sources to be combined productively to create a business through limited liability corporations. Under the law, a corporation is an autonomous entity with rights and obligations enabling it to act as a business. But, since informals do not have access to formal law, they cannot benefit from such organizations. Among other things, they cannot limit their liability to the amount of their capital contribution, they cannot combine inputs efficiently, they lack the means for receiving intangible contributions, they lose the stimulus to invest over the long term, and they cannot share risks with other investors. As a result, informals have little choice but to associate themselves, almost tribally, with close family members and to limit themselves to artisanal production and small firms.

Torts. A final facilitative function of the law is to repair or prevent the effects of a person's actions, not foreseen in specific contracts, on others. For this, formal society establishes a system of torts, or extracontractual responsibility, which requires compensation for those injured by negative externalities.

In Peru, while informals may have established extralegal norms, they lack enforcement power. Thus, informality brings a series of uncompensated negative externalities. For example, in Lima there are 14 times more deaths in transport than in Western European countries. A similar thing occurs with the street vendors. They leave a great deal of garbage around, congest the streets, and, in some cases, sell food products without any sort of sanitary control.

The result is that private activity in the country, above all that of the informals, loses prestige because it causes serious problems that are not corrected. As a result, public opinion, with the help of antientrepreneurial ideologues, tends to identify the problems as the negative consequences of private enterprise. In transport, for example, common people identify informal bus companies with the chaos they suffer and tend to demand that the state take their place without seeing that what is really needed is an effective system to deal with negative externalities, i.e., a tort system.

The lack of this facilitative element reduces the real contribution of the informal sector, turns people against private enterprise, and induces its substitution instead of optimization.

Other Advantages of the Law. Obviously, popular entrepreneurship functions poorly without adequate institutions. To the limitations listed above, many more can be added. Lacking formal status, informals do not have access to credit nor can they advertise effectively. For fear of detection, it is virtually impossible to achieve economies of scale. For lack of coercive power, they cannot develop the public goods they need nor stand up to the power of monopolies. And the lack of courts and tribunals that function efficiently means that more conflicts end up being resolved violently.

The ILD believes that Peruvian society is not taking advantage of its opportunities nor has its potential been discovered. The value of production has not been maximized. The cost of transactions is clearly greater than it would be under an efficient juridical system. The lack of facilitative law is, perhaps, the best explanation of why individuals pursuing their own interests in our country do not serve those of others.

The Cause: Mercantilism. Once the importance of legal institutions in development was established, the ILD set about answering questions such as: how were these obstacles that cause informality and damage the formals generated? Why hasn't the law in Peru adapted itself to the needs of a diffuse, popular business class? On inquiring into how laws are created in our country, it was discovered that, to a great degree, they were dictated without any procedures to ensure oversight by or accountability to the electorate. There is no "rule making," no "comment and notice periods," no public consultations through hearings, no cost-benefit studies of the foreseeable consequences of the approved norm; and there is no way to make the state or the authorities accountable for the norms once they have emitted them.

From 1947 to 1985 the executive branch emitted annually 99 percent of the Peruvian rules and regulations while Congress approved only 1 percent. Thus, on average, 99 percent of the 27,400 rules and regulations emitted annually are passed without the most minimum "rule-making" procedures to ensure oversight and accountability by either the elected officials (parliament) or the citizenry. As a result, the legal norms respond to the interests of public functionaries, politicians, and those with access to the power of the state, without any consideration for the costs imposed on the rest of society. This, we believe, is directly linked to the obstacles both formals and informals face, and to the lack of facilitative law.

Such evidence makes clear the way in which the Peruvian state governs. The only citizen participation is a system for electing a government every five years. There is nothing to democratize decision making. Obviously, this is equivalent to making out a blank check to the president. As time passes, this has negative repercussions on the government's own legitimacy as it has no structured way to receive feedback from citizens on its actions. This helps to explain why democracy in the country has lost so much respect and why governments are so weak at the end of their mandate. There is a close relationship between the lack of an institutional structure that allows a market economy to operate and lack of one that allows a democratic system to function in the country.

This centralization of power in a group of authorities also relates to geographic concentration of investment in that all investors need to be close to the power. One indication of this is the fact that most provincial companies maintain their general managers in the capital city, far away from their factories, because they can get better output from negotiations with the authorities for favorable rules and regulations than from directly supervising production in their plants.

To place this type of regime in context, the ILD has compared it with mercantilism which predominated in Europe between the fifteenth and nineteenth centuries. It was a type of capitalism without free markets or competition. With the pretext of redistributing wealth, production was hindered and those with privileged access to political decisions were favored. In both cases, the past and the present, the mercantilist state is characterized by its bureaucracy, excessive regulation, and politicization. And the law, instead of being nourished by reality, responds to the vision and interests of the few with access to it.

Both Karl Marx and Adam Smith were critics of the internal contradictions engendered by this system. As it decayed in Europe, it was replaced in the West by participatory democracies with openly accessible markets. In the East it was replaced by communism. The ILD argues that the rapid growth of informality suggests that mercantilism is now decaying in Latin America as well.

The crucial issue is how to help the system evolve into one that provides economic and political liberty for all. While the mechanisms of transition to communism are well known, those of evolution to a modern democracy are not. It is to this critical question that the ILD program addresses itself.

The Road to Reform. The informals are not only a symptom of the problem facing Peru, which is its mercantilist structure of governance, but also a potential route to reform. Representing some 60 percent of the population, they are a potent source of support for reforms that would give them a stake in the society. Thus, not only have we configured the problem but we have identified the direction in which a solution lies.

At the heart of the economic development problem of Peru and, by inference, much of the Third World, lies a closed system of economic and political decision making. Informality is a symptom of this institutional dysfunction. The route to reform lies in opening up the system of decision making to all. To do this, the ILD has developed a public education and participation program titled "Everybody's Balcony."

Issues are brought to public attention through a series of articles and flyers called ABIPs (Analyses in Benefit of the Public Interest). They are published biweekly in the leading magazine and newspaper, reaching some 800,000 readers. They focus on analysis of a problem and include specific suggestions by the ILD as to how the problem might be resolved legally. Public meetings are then held at a local level to discuss the issue, and these are followed by public hearings. Based on input from the meetings and public hearings, the ILD revises its proposed law and submits it, publicly, to the appropriate authorities.

To date, all four of the laws proposed by the ILD have been picked up by the authorities in one form or another. On titling of homes in Lima, we proposed specific reforms in the ABIPs. We followed the ABIPs with public meetings at which our proposed legislation was discussed. Following the public meetings, we asked people to register their complaints against the existing system with us. We received 300,000 complaints in one month. The impact was not lost on the politicians. President Garcia immediately proposed his own titling law which was passed by Parliament, with a few modifications suggested by the ILD. The Apristas (at the national level) and Communists (at the municipal level, who are traditionally against private property) then began to fight among themselves for the privilege of being the ones to offer titles to informally acquired land.

Several of our other legislative proposals have been picked up by different political groups; our Freedom of Information Act was just recently introduced into Parliament by PUM (the far-left party), our Administrative Simplification Law has been introduced by a multiparty group and is now in committee, and our Housing Construction Title Law (simplifying the process of certifying home ownership) was taken up in various forms by the municipalities of Lima and Callao (United Left and Apra governments) and the Ministry of Housing.

There are two immediate conclusions to be drawn. The first is that, ideologically, much of the left appears to be soft: they are less committed to the tenets of Marxism-Leninism than they are to achieving change that is popular with their constitutency. Second, the use of a private ombudsman system, Everyone's Balcony, is an effective mechanism not only for demonstrating how democratic participation works, but for achieving reform.

Implications of the ILD's Activities

Although much more research and analysis is necessary, what the ILD has done to date has begun to undermine the major antidemocratic and antientrepreneurial theories current in Latin America today. It has done so by demonstrating conclusively that some of their fundamental assumptions about the nature of the social and economic order are simply incorrect. This is certain to have practical consequences since the policies current in Latin America today are backed by one or more of these development theories.

It is important to realize that Latin American political culture is characteristically more theoretical and somewhat less pragmatic than that of the United States. The ideologies that give form to the political culture lead not only to policy; they condition the way in which people think. Thus, to effect change, it is crucial to deal not only in terms of policies but in terms of the ideas that motivate people and guide their action.

In the following subsections we indicate, first, what the core concepts of each ideology are and how they translate into policies, and, second, how the ILD's findings undercut these ideologies.

The Cultural Hypothesis.

The Theory. Many theories, ranging from the anthropological, based on ancient Indian forms of organization, to the political, rooted in Marxism-Leninism, take off from the premise that Latin American culture, particularly that of the Indian and mestizo, is basically antientrepreneurial in the Western sense of the word. The result is a widespread belief that a Western-style democracy and a market economy are not natural components of Latin American culture. Therefore, any attempt to foster a society based on entrepreneurship and democratic participation is immediately labeled as cultural imperialism.

The ILD Position. Our research into the informal sector undermines this argument. An important part of the findings describe the incipient market economy and democratic systems spontaneously generated by the informals. We believe that one of our major contributions is the description of the extralegal norms, or common law, created by the informals once they arrive in the cities. We have found no dictatorships or mafia-type organizations, no kolkhoz or ayllus but, rather, individual or family ownership, and rules that attempt to create fair competition through extralegal norms for property, contract rights, and torts. When large segments of the population, and primarily indigenous ones at that, have set up participatory democratic structures and a market economy, then in no way can such structures be considered alien to Latin America.

Secondly, it is clear that part of the problem is definitional. It must be realized that what is broadly termed a market economy—that existent in the formal sectors of Latin America today—is not that at all, but a mercantilist economy. Thus, those who would discard a market economy on the basis of the results of Latin America's present day economic structures would, in reality, discard not a market economy but a mercantilist one.

This is not to deny the importance of culture, but rather to indicate that there is no basis in Latin American culture to declare a participatory democracy and market economy incongruous with national inclinations. It is obvious that the manner in which we Latins conduct our activities and manifest our preferences reflects both culture and ideology. But, if we are to overcome barriers and open the road to reform, then we must be willing to carefully examine preconceived ideas in the light of what people are actually doing.

Marxism-Leninism.

The Theory. All variants of Marxism teach that capitalist society is a system of domination and subordination with economic roots deriving from control over the means of production. Market relationships, particularly those between "free" wage laborers and the capitalists who contract for their services, are never relationships among equals but conceal domination and exploitation. Politics, as such, including the legal prescriptions and institutions, are merely a reflection of the economy and the structures of domination that it establishes.

Essential to Marxist orthodoxy is the notion that domination is embodied in a dichotomous social structure composed of two fundamental classes. In the Marxist view, classes are composed of all those who share a similar position or orientation with respect to control over the means of material production. In capitalist society these are the bourgeoisie (capitalists) and proletariat (wage-workers). They are related dialectically in that the on-going development of capitalism necessarily causes the proletariat to increase in size, class consciousness, and antagonism toward the capitalist order. Therefore, the proletariat is the "universal class." Its condition of exploitation and subordination represents the condition of all but a tiny handful of oppressors; and its conditions of liberation represent the liberation of all. This dialectical process—i.e., the unavoidable development within the bowels of the capitalist system of a new, implacably hostile, and eventually majoritarian oppositional force—forms the basis of all Marxist politics.

The ILD Position. Our findings undercut local Marxism-Leninism in two ways. First, they make clear that the economic system operative in Peru today is not modern, market capitalism as it is known in the developed countries, but mercantilism. Thus it positions itself against the "same control by special interests" as do the Marxists. Second, our research revealing the size of the informal sector negates the orthodox understanding of domination by demonstrating that a large part of the society in Peru is not proletarian in any sense. Instead, this group is basically entrepreneurial in its interests and world view. As documented in *El Otro Sendero*, its primary objective is to secure rights of property—a bourgeois rather than proletarian objective in Marxist terminology. That the informals happen to be poor and culturally different from the more traditional middle classes in no way affects their objective class situation or interests. What is more, the ILD's research, particularly when considered in the light of comparable trends away from traditional factory employment in the developed countries, suggests that, far from becoming the "universal" or even a majoritarian class, the pure proletarian is a minority. Of the economically active population in Peru, formal workers represent 20 percent and organized labor, 4.8 percent. Thus, any Communist revolution in Peru that would claim to be "proletarian" would represent a dictatorship of a minority of the society over the majority.

Latin American Marxist parties have tried to get around this inconvenient fact by subtly redefining "proletarian" so as to embrace all who are left out, exploited, or oppressed by capitalism, whether or not it occurs by way of the wage system. To do otherwise—to admit that the proletarian condition is nowhere near universal—would undermine the fundamental base of their ideology.

To the degree that the informals do feel excluded and blocked from socioeconomic advancement, they can be expected to support any political movement that allies itself with their interests. Pressed hard enough, they will become revolutionary. In other countries—Italy in the 1920s, Argentina in the 1940s—the poor have supported fascism. In Peru, for specific historical reasons, they now support varieties of political Marxism. In fact, Marxist ways of thinking command considerably more support among the mass of Peru's population than does any other single ideology, as the outcomes of the last two elections indicate, especially when it is recalled that Aprismo is rooted in Marxism.

Unlike the proposals of the Marxists, those of the ILD are based on the empirically identified class interests of the people who are to be aided and offer practical remedies that depend largely on their mobilization on their own behalf. Even if Marxism has had some success in co-opting urban informals by fighting for their rights, studies have shown repeatedly that these people support it for purely tactical reasons and rarely, if ever, share its larger vision. A recent political incident in the Lima barrio of San Martin de Porres confirms that this approach exists, even among fairly high-ranking Marxist party cadres. The district mayor, an official of the most "hard-line" component of the United Left coalition, was attracted by the value of the ILD's proposals for the needs of his constituency. He asked us to design the program specifically for his district and publicized the ensuing joint venture. His daring initiative subjected him to intense political pressures from the party leadership and he was ultimately forced to undergo a humiliating public "self-criticism." However, following this incident, three of the council members came to work with us, attracted by the practical solutions proposed. There are numerous other examples of support for our positions by those of supposedly Marxist inclinations. For example, the parliamentarians of United Left Party have been among the main supporters of various ILD legislative initiatives. Much of the press on the left has also been supportive, designating *El Otro Sendero* "a support to the construction of socialism in Peru." What all of these examples indicate is that practical solutions to reform the system have much more appeal to most than empty ideological abstractions.

This demonstrates precisely the danger that our research represents for Marxism-Leninism. Because it has defined the situation of the informals correctly, in class terms, whereas the Marxists have not, there is every reason to believe that the ILD analysis should win this particular contest at both levels: by attracting the base of support or changing their outlook, and by instituting changes that have real and beneficial consequences for the informals. It is very hard for ideologies that operate largely in the realm of values and are thus resistant to empirical falsification to survive for long if they clash continually and fundamentally with lived experience. It is also interesting to note that one of the leading Peruvian Marxist theorists has already stated that the ILD's position represents the third option on the Peruvian ideological scene, along with Marxism and Aprismo.

Dependency Theory.

The Theory. Dependency theory is distinguished by its insistence that the biases of the international system are rooted in capitalism as such. Beginning around 1950, the U.N. Economic Commission for Latin America (CEPAL in Spanish) began to develop its structuralist theory of economic underdevelopment. It posits that the world capitalist economy embodies an international "division of labor" that is structurally biased against the interests of the newly industrializing countries. Such biases take the form of "unfair" terms of trade, the transnationalization of capital, the "monopolization" of technology by transnational firms, and so on. CEPAL thus concludes that only inadequate or "distorted" development is possible for a country that participates fully in the world economy. The remedy is said to be a significant degree of withdrawal from the world economy and the implementation of an inward-looking strategy of industrial promotion. This strategy typically has taken the form of import-substitution industrialization.

Then, starting in the early to mid-1960s, leftists found a way to combine CEPAL's structuralism with Lenin's ideas about the inherently imperialist nature of capital on a world scale. Lenin argued that certain internal "contradictions" of the capitalist system required the systematic colonization and exploitation of the world "periphery" by the developed countries of the "center," since otherwise the system would collapse. To this the leftists added two innovations. Whereas Lenin had pictured the "center" as rent by "interimperialist" rivalries and doomed to constant warfare, the new paradigm portrayed the "center" as a cohesive structure of domination organized and led by the United States. And whereas Lenin had relatively little to say about the detailed forms that this "exploitation" assumed, the new paradigm professed to find these forms in the structural features that CEPAL had identified. This marriage of Leninist theory and "Cepalismo" became known as "dependency theory."

Dependency theory has stimulated a vigorous debate in the field of development studies and has spawned an enormous number of publications pro and con. Today the overwhelming weight of the evidence is heavily against every one of the core dependency propositions. Likewise, the policies which emanated from it such as import substitution industrialization, the favoring of foreign borrowing over foreign investment, subsidization of urban consumers at the cost of undermining agricultural production, have proved to be counterproductive, particularly when implemented by a mercantilist state.

However, the dependency idea has acquired an ideological presence independent of its failures as theory. There are three reasons for its continuing appeal. The first is that it is an eminently nationalistic ideology in Third World terms. In fact, it is the characteristic form assumed by Latin American radical nationalism in our time, which points to an important historical lesson: nationalism, not Marxism, has consistently proven to be the most attractive political ideology of modern times. Second, dependency theory enables Third World political leaders, along with the oligopolistic, privileged, corporate elites who associate closely with them, to shift the blame for their policy failures onto the shoulders of an international system for which these leaders and oligopolists could not be expected to be responsible. Finally, the apparently radical features of dependency theory give the leaders who cater to exacerbated nationalism a way of co-opting local Marxists and/or of appealing directly to the Marxists' ideological constitutency.

Since dependency theorists equate development with large-scale, high-technology industrialization, they have rarely paid much attention to the informal sector except to ratify CEPAL's claim that its presence reveals "distorted development." A partial exception to this neglect, however, is the work of the Regional Employment Program for Latin America and the Caribbean (PREALC), an arm of the International Labor Organization (ILO). PREALC embodies an institutional and theoretical bias in favor of viewing the problem of informality as one of employment instead of entrepreneurial outlets and opportunities. Its policy recommendations, which call for the aid and protection of the state, contain an implicit assumption of informals as unemployed proletarian victims while ignoring or not perceiving their qualities as independent economic actors in need of a sound legal-institutional regime that would grant them opportunity.

The ILD Position. This position undermines dependency theory in three ways. First, the dependency position falls to the ground as soon as it is shown that most of the "distortions" it identifies can be corrected by purely local measures that have nothing to do with the country's relations to the world economy. For if local solutions suffice, it is obvious that the main source of the "distortions" was local all along and could not have resulted from international economic structures. The ILD has identified these local sources and recommended purely domestic policies to eliminate them.

This is not to say that the international economic system is necessarily just and free from bias against the Third World. Rather it points out that there are steps Third World countries can take, irrespective of the international economic system, which will improve the condition of their people. It introduces a note of optimism in the face of the deep pessimism of dependency theory, which posits that nothing can be done until the developing countries break completely with the international capitalist system.

Second, as noted above, our research to date suggests that much or most of the informal sector is entrepreneurial rather than proletarian in composition. Therefore, what it needs most are entrepreneurial opportunities, which will create more jobs, rather than measures designed to cause confrontation between the proletarian and entrepreneurial classes.

Third, one of the strengths of dependency theory is its nationalist appeal. What the ILD's position has done is to substitute a positive nationalism, based on indigenously developed institutions and incorporating much of what is distinctly Peruvian, for a negative nationalism based on opposition to foreign models.

Liberation Theology.

The Theory. Twenty-odd years ago there arose a Latin American variant of European "political theology." It first took institutional form as "Cristianos por el Socialismo" in Chile during the Allende period, although its best-known current embodiment is the Sandinista "Iglesia Popular" in Nicaragua. The prominence of Liberation Theology as both a political ideology and as a movement is particularly noteworthy in Peru and Brazil, where two of its major proponents (Gustavo Gutierrez and Leonardo Boff, respectively) reside. It has gained strength within a surprisingly high strata of the Catholic church hierarchy in addition to the priesthood and laity. It also enjoys a considerable following in the United States, especially within those priestly and monastic orders that operate programs in Latin America.

Liberation Theology is not and does not pretend to be a theory of development. The "theory" that it offers, and the prescriptions for action that it derives therefrom, have been borrowed directly from Marxism and dependency theory.

It adopts from dependency theory the explanation of the plight of the poor as beset by an unjust economic system, applying to them the new definition of proletarian as synonymous with the poor and propertyless. It generally seems to accept the Marxist idea that class interests in capitalist society are antagonistic and cannot be harmonized. What Liberation Theology adds to both dependency theory and Marxism is the moral justification for the right of the poor to organize themselves and revolt against the existing system.

Liberation Theologians maintain, without deviating from the Church's long ideological tradition, that a solidaristic, cohesive society is God's plan for humanity. They continue to find in the capitalist system and underlying individualistic ideology the principal impediments to the realization of this plan. And, like the earlier Catholic corporatists whose lack of a political strategy ended in overt support for fascism, they seem to have no way of assuring that their new political order will be any more just than the old one.

The real question is whether social revolution—as opposed to other, less apocalyptic strategies for helping the poor to help themselves—is truly central to Liberation Theology; or whether, on the other hand, a small number of Marxist extremists have managed to bend the Church's old antiliberal currents to their particular purposes. Without doubt the question bears further investigation. In the interim, three points must be registered in Liberation Theology's favor. One is that it represents the Church's recognition that economic circumstances are a central element of the human moral as well as material condition. Second, this makes the attainment of a just and moral social order in the church's conception extremely unlikely in the absence of fundamental change. And, third, its strategies of action emphasize empowerment of the poor from the bottom up in place of their organization from the top down by a dictatorial party-state.

The ILD Position. The proposals of the ILD are by no means utterly out of tune with the moral thrust of Liberation Theology. The ILD, too, identifies structures of power in the existing system that embody special privilege, that are biased against the poor, and that must be overcome through direct political action. It stresses the self-organization of informals as one of the principal, viable, political means by which reforms can be enacted. And it abjures the extremes of self-interested individualism, in the negative context of a mercantilist society, maintaining that deliberate efforts must be made, both at the level of the state and at the level of civil society, to assure equality of opportunity for all.

Thus, we would not claim that the ILD's work in any way undermines the social concerns expressed by Liberation Theology. It does, however, undermine any strand of political ideology, even if disguised as theology, which insists that there is no way to improve the lot of the poor short of all-out revolution and the elimination of entrepreneurship.

As we are not theologians, we have no desire to interject ourselves into the deeper theological debate now raging within the Catholic Church over the issue of Liberation Theology. But as concerned lay people we know of no basis in Catholic doctrine for opposing systems based on widespread entrepreneurship per se, if they can be made to operate fairly and justly—as we believe they can. In fact, the ILD's case studies should challenge Catholic social thinkers to give renewed attention to the need to reconcile morally the just aspirations of individual human initiative with the goal of a just society.

The Foreign Policy and Assistance Programs of the Developed Countries.

The Problem. Developed countries have faced two problems in achieving concordance between their basic values and their foreign policy and assistance programs. The first is that they have often confused mercantilists with modern market systems and democratic elections with full-fledged participatory democracy. Yet, as the ILD's research has shown, the mercantilists are not capitalists of the type found in the Western world and democratic elections in no way guarantee citizen input and oversight in the rule-making process nor any accountability whatsoever. Thus, many Occidental nations have often ended up supporting regimes whose practices bear little resemblance to the values for which they stand.

Second, the West has traditionally attached great importance to stability, believing it crucial to economic growth and, generally, to Western interests. Because in many Latin American countries, stability supports the existing mercantilist structure, efforts to change it have primarily come from the Left while the West has been identified with support for the status quo. Yet, as our research has demonstrated, the status quo is contrary to, rather than supportive of, economic growth and political democracy. Since the majority of the population, including the informals, does not generally support the status quo, Western policies are identified with the existing oligarchies.

In terms of foreign assistance, the same misconceptions mean that Western foreign assistance has often failed to bring the desired results. It has promoted the state by concentrating funds (and, therefore, power) in the hands of politicians and government bureaucrats. It has strengthened the business elite, mistakenly identifying them as competitive entrepreneurs like most of those in the West. It has helped create and maintain a labor elite that has become part of the mercantilist structure. And it has provided charity to the poor which, while admirable in humanitarian terms, has not helped them to change the institutional structures impeding their progress.

In addition, by supporting, or appearing to support, special interests, Western developed nations have been playing into Marxist hands. The Marxists have identified themselves with the interests of the "proletarians" whom they have redefined to include the poor and oppressed. Thus they are seen as standing for change in the present structure while the West is left as the guardian of the status quo.

The ILD Position. By identifying the ruling structure as mercantilist—antidemocratic and antimarket—and proving that it is the poor—and majority—who support and practice democracy and accessible markets, the ILD's research has given the West the opening to place itself squarely on the side of democratic participation and economic opportunity. The primary effort in passing from a mercantilist to a democratic, market-based society is, of necessity, a local one. But foreign governments through their policy and assistance programs can slow the process or encourage it. ILD's program points to some of the things we in Peru must do if we are to reform our society. And, therefore, it suggests the direction that Western policies and assistance programs should take to assist in this process.

The External Debt.

The Problem. There is a growing consensus that the austerity programs imposed on the debtor countries by the IMF are not having the desired results. Developing countries can tighten their belts only so much without inviting political instability and destroying the base for future economic growth.

On the other hand, it is now generally accepted that heavily indebted countries, such as Peru, need to fundamentally reform their economies in order to promote private sector initiative and, in return, receive assistance in fulfilling their external debt obligations. However, none of the programs undertaken to date to alleviate the debt problem have been successful.

Lamentably, these discouraging results are not surprising. Conditional loan programs necessarily demand that the governments of the debtor countries subordinate management of major portions of their economies to the criteria proposed by foreign governments or multilateral institutions. The result is reforms executed "from the top down," without consideration of the political consequences. The majority of these reforms—reduced restrictions on foreign investment, reduction of tariffs, elimination of exchange controls—pose the risk of offending powerful local interest groups and do not have any apparent connection with the interests of the poor. Thus, the governments of the debtor countries are understandably hesitant to adopt them even though they could help alleviate the debt. This was clearly the case with Peru's announcement that it was limiting payment of its debt to 10 percent of its export earnings. While this action may not have won President Garcia friends in the international banking community, it clearly was a plus in terms of building internal political support. The actual forces of reform promoted from outside ignore the necessity of generating internal political support. As a result, they can have only limited success at best.

Even more important, conditional loan programs ignore the vital role of institutional reform at the microeconomic level. As our research has demonstrated, countries such as Peru lack many of the institutional prerequisites for facilitating economic growth. A legal system that does not guarantee the fundamental rights of property, contract, legal process, and commercial organization to the majority of its citizens cannot maximize incentives to innovate, invest, and produce. At the same time, the legal system imposes excessive charges on the private sector through red tape and regulation, discourages private initiative, and increases the costs of goods produced. In this setting, the traditional prescriptions of structural reform are destined to fail because they do not get at the heart of the problem, which is a mercantilist structure that limits competition, functions on favoritism rather than efficiency, and represses entrepreneurship.

The ILD Position. The ILD argues that the presence of informality, although it signals an institutional problem, also contains within itself the germ of a solution. If the informals can continue to be educated to understand that they are victims of excessive governmental interference in the private economy and, in addition, that they themselves would be the principal beneficiaries of market-oriented reform programs, then it should be possible for the informal sector to provide the political support necessary to carry out these reforms.

Informals have begun to recognize that their interests lie in market-oriented reforms—as illustrated by the manifesto by the leaders of the 300,000 member Federation of Transport Drivers of Peru requesting ILD's assistance in developing a private-sector-based transport policy. It seems clear that once informals can clearly identify their interests with good economic policy, as in the interest of the transport drivers in greater access to imported spare parts and finance, they will support policies that will help solve the debt crisis for the developing countries.

Therefore, methods that now seem to favor foreign interests, could be seen as benefiting the majority of Peruvians. What is even more fundamental, the implications of the ILD's studies are starting to demonstrate to the Peruvian public the virtues of the markets and the democratic practices the informals have unconsciously developed.

Increasing Economic Growth[1]

The Problem. The imperfections in Peru's legal and bureaucratic structure not only severely disadvantage the informal sector, they significantly dampen economy-wide growth. Because they are not officially recognized, informals do not have access to the basic institutions that formal enterprises in Peru, and in other countries, take for granted. Because they lack formally recognized collateral, informals cannot obtain credit from formal lending institutions, which charge far lower rates of interest than informal lenders. Informal enterprises do not enjoy the protection of contract rights and cannot form corporations to take advantage of limited liability. They cannot get insurance. They must continually worry about detection by the authorities, and when caught, must pay bribes that divert resources from use in productive activities.

In short, informals fear expansion, have little means of financing it, and possess no way of legally protecting the fruits of their endeavors. The net result is that informals cannot realize economies of scale and have few, if any, incentives for attempting to do so. It is not surprising, therefore, that labor productivity (GDP per man-hour) in the informal sector has been estimated by the ILD to be only one-third that of the formal sector.

The formal sector, too, suffers under the weight of excessive regulation and red tape which stifles initiative and raises costs. Equally important, the growing number of citizens who are deserting the formal sector leave behind fewer individuals and entities to bear the nation's tax burden.

The ILD Position. Even with the best macroeconomic policies, such as realistic exchange rates and fiscal balance, Peru would still remain far below its economic potential. An effective package of internal structural reforms promises potentially significant economic benefits beyond those obtainable from implementing suitable macroeconomic measures to stimulate economic growth.

In principle, microeconomic, internal structural reforms would produce economic gains of two types. First, by removing the current obstacles to expansion and investment of informal business, they would raise productivity (output per man-hour) in the informal sector. Second, by eliminating wasteful regulation, they would reduce costs for formal enterprises and thereby free resources to be employed in more productive activities. Both gains would increase Peru's GDP and, under certain circumstances, would also increase the country's capacity to repay its foreign debt.

It is difficult to estimate with precision the economic benefits from adopting particular internal reform measures. Nevertheless, it is possible to make at least a rough estimate of the potential gains from effective internal reform by calculating the increase in output that could be realized by narrowing the existing productivity differential between the informal and formal sectors. These gains would materialize because formalizing currently informal activities would allow informal entrepreneurs to expand to more sophisticated technology, as well as the credit with which to purchase it.

If, for example, half of the current productivity differential between formal and informal firms were narrowed over a ten-year period, GDP would be 2.4 percent higher per year than would otherwise have been the case. Considering that Peru's average GDP growth rate between 1973 and 1983 was 1.9 percent, the improvement would lead to substantially higher growth rates. This estimate does not include the additional gains that would be achieved through reduction of the costs and improvement in the efficiency of formal businesses.

The rate at which the economic benefits from internal reforms could be realized would depend on both the rate at which new policy measures were introduced and the availability of capital to finance the expansion by informal businesses to efficient scale. However, there are several reasons for believing that the availability of capital need not be a significant constraint.

First, the deregulation of bank deposit interest rates would increase real interest rates on the dominant asset (bank deposits) in which both formal and informal Peruvians hold their savings. This would not only permit an increase in wealth, but would promote domestic savings, which would, in turn, increase the available pool of capital for the entire economy. This would benefit both formal and informal borrowers.

A second source of internal financing could be provided if the Peruvian government were to divest itself of state-owned enterprises, which currently require state subsidies that absorb private savings which would otherwise be available for private investment.

In short, it is likely that, in Peru, substantial increase in private investment by enterprises that are currently informal could be financed internally, without additional foreign investment or borrowed funds. Of course, if foreign financing were available and were channeled to Peru's private sector through a credit system that allocated funds by price, even greater sums could be available for investment by currently informal entrepreneurs.

Conclusion

While many countries, particularly in Western Europe, have made the transition from mercantilism to modern states, they did so through a process of spontaneous evolution that remains to be charted. Therefore, our plan is to research and map out the steps required for said transition in the context of Peruvian and other Latin American realities and continue implementing our proposals as the best test of their viability.

Concretely, in Peru, we plan to focus our efforts on four principal areas:

- opening up economic participation;
- creation of institutions to control and make accountable the monopolistic exercise of government power;
- creation of institutions to decentralize and deregulate government power;
- education of the public to mobilize support for change.

The evidence gathered so far suggests that stable development will be possible only when mercantilist institutions are changed for those of a modern market economy and participatory democracy. ILD is dedicated to facilitating this transition. It does so with the knowledge that sustained and equitable development is most certain to occur when the energies and aspirations of individuals find expression in an atmosphere of economic and political freedom.

James Payne

Comment

It occurs to me that as well as being a discussant here on Hernando's paper, I'm actually a physical exhibit of the informal sector in Peru. When I was there in 1961, I was there as a university student and found out I had to get a resident visa. After going through the bureaucratic types of steps he described—to this office and that office—I finally got to the last bureaucratic step. It turned out that according to the law, I had to pay an incredible fee for this nonresident visa, something like $500, which was all the money I expected to live on in Peru for that year.

I pointed this out to the official, who apparently sympathized with my plight. He looked at my application and, pointing to my birthdate, said, "Well, it doesn't apply to you; you're a minor. You're not 21 yet." Well, I could add and subtract, and I did it again and was 21, and I said, "No, you're wrong, I really am 21." He said, "No, no, no, you don't understand." I apparently was a little dense about this, but he finally convinced me that his addition was more accurate than mine; it turned out I only had to pay $6 to stay in the country. So if Hernando is an entomologist of the informal sector, I'm a bug here for Exhibit A. [Laughter.]

Ever since I first heard about Hernando's work, I found it a breath of fresh air in the whole development discussion because it puts such a different perspective on everything. As he recounts in his summary of the different ideological positions, *El Otro Sendero* really is "another path." It takes us all a bit of mental digesting to figure out how to fit it into what we believe.

I feel my function here is to lay out some thoughts for discussion. I see two main issues in Hernando's paper that perhaps caused some of the misunderstanding that exists between his perspectives and those of the paper by Biggs, Grindle, and Snodgrass.

Perhaps I can focus the first issue with this question, Do we want the informal sector to grow and prosper? Is it something we want to treat as a beneficiary of A.I.D. programs and other government programs? At first this might appear to be Hernando's perspective. The title of his paper is "The Origins of Underground Economies and Limits to Their Growth." One overtone of that is that we should remove these limits so that underground economies will grow bigger. I think the Biggs et al. paper has taken up that overtone: Do we want to subsidize this informal sector? I think they tended to conclude that maybe we should not, that it's not an attractive long-run area for our efforts. So one interpretation of what this informal sector is, is a group of beneficiaries that we are trying to aid through government programs.

A completely different interpretation—and I think it's the one that dominates in Hernando's work—is that this informal sector is a sign of a problem, of something wrong in the local political economy. To clarify this interpretation, we should not be fuzzing it over with this nice-sounding phrase "informal sector"; instead, we should go back to "illegal sector." That is, the sector of people that are operating, in one sense or another, contrary to the laws and government regulations that exist.

In this interpretation, the informal sector is not something we want to see grow. We want to see it shrink. Hence, the policy aim should be to dismantle this edifice of government and government regulation that is holding back legitimate and creative human activity. This, I believe, is Hernando's basic position.

If you agree that it is the excessive growth of government regulations that is the problem, how do you go about changing it? What is the way of making progress here?

Here again, I find two different perspectives dominating. The first one—and I think this is perhaps the main thrust of what I see in Hernando's work—is that the rules and restrictions have come about intentionally. That is, they were meant to do harm to a lot of people and meant to benefit a small number of people. Here we come to the use of words like "oligarchy" or some type of sinister "elite," the idea that some group got hold of government to try to hurt everybody else.

Now, if this is your view—and it is a very widespread view—then the tendency is to want to form a party or lobby to get hold of government, to throw the rascals out, and to get in yourself, in the belief that you are going to be fair and high minded. I would say that all kinds of political parties, including the Marxist-Leninist organizations, have this perspective. They believe that what has gone wrong in society has been caused by some small group with evil intentions.

A second viewpoint that I would suggest you at least consider is that these problems—in this case, these rules and regulations that suffocate normal entrepreneurial activity—come about as a result of people who start off with good intentions, hoping to institute certain types of policies or reforms that improve society, and that these miscarry as things so often do in government.

Now, if the very regulations that today are hurting taxicab drivers or homeowners or squatters and so forth, can be traced to some good intention of 50 years ago, then we have to reorganize our thinking about our good intentions today. In other words, are good intentions enough? Should we not ask, as a first step whenever we propose reforms, how they might go wrong? What are they going to look like 50 years from now? How can they do harm? What if they don't get carried out in the way I intend (which is almost always what happens to reforms)? In this peaceful room in Washington you say, "Let's do X." Unfortunately, by the time generals, assistant secretaries, and everybody else is done with them, reforms don't look like anything you intended, but they are there. And then they will be hurting people.

So I'm wondering whether he might be arguing for creation of another pressure group to push for "reform," and I'm wondering whether this might just produce a new layer of government in the long run.

Discussion

MR. de SOTO: I think you've addressed the problems as I understand this particular forum wishes to look at them, which are, "What can you do about the informal sector?" and "How can you help them?"

One of the issues raised by the Biggs, Grindle, and Snodgrass (BGS) paper is the fact that direct assistance methods to the informal sector could create a growth trap, that the informal sector is not necessarily something that's desirable. It's a positive indication that there is entrepreneurship where people thought there was no entrepreneurship; that there are all the basic institutions, the fledgling institutions of what could grow to be a mature market economy there. But as such, they suggest the informal sector is something that you don't want to remain.

And I would agree with that position. I don't think the informal sector is at all desirable. The informal sector lacks a lot of institutions which are crucial just for human rights. Informal sector justice is a very cruel justice: the lack of courts, the lack of good property rights, the lack of contracts.

Let's take the case of, for example, property rights, which I think is one of our important contributions. There is at the level of extralegal norms, a property right law in Peru for the informal sector. Otherwise, there wouldn't be that much building. As you know, in Lima there is over $8.4 billion worth of informal construction or housing, and that housing would have been impossible if there hadn't been some type of property rights definition by the informal sector. So undoubtedly, the fact that this parallel institution existed allowed for the creation of a wealth that wouldn't have been there in the first place.

But one of the things we found out through a series of empirical observations is that where the same kind of people were involved but some of them had property titles—that is to say where the government authority gave somebody who was traditionally informal a property title saying that that property was his and could not be violated at least by the state—the value of that titled property increased nine times over ten years. In other words, informal law is fine, but it is only one-ninth as good as formal law in terms of insuring adequate defense of property rights.

So do you want the nine times better property right or do you want the one-ninth of the nine times better property right? And obviously, what you want is the formal sector; what you simply don't want is an inefficient formal sector that does not take into account the majority of the population; you do not want a corrupt formal sector; you do not want one that takes months to give Jim a residence permit, and one that takes almost seven years to give you the right to a dune of sand. These are things that you don't want. But you do want a good formal sector.

The ideal objective I think one should aim at is undoing the informal sector. The question is how you do it, since as the BGS paper says somewhere along the line, aid donors have discovered that political impediments to reform often weigh more heavily with decision makers than do the economic benefits accruing from adoption of significant policy reforms. They go on to say that opposition to structural change from interests, bureaucracies, and state-led development ideology is very strong, and it doesn't allow you to make decisions. So what you have to do is change that decision structure.

What we have seen in Peru, as you may have read, is that we produce at the national level 27,400 rules a year, and that 27,040 of those rules are produced by the executive branch; that is to say, 99 percent of them. Once we have elected a government, that government produces them at the rate of 111 per working day, and there is absolutely no way that formals, informals, Jim, or I can intervene and say that's a bad law. They've got no feedback when they produce these bad laws.

And what we have seen is that the way we make rules is very different from the way you make rules. When we have proposed a system of democratic rule making in Peru, we've proposed nothing different from what you and Western European countries have; after having elected your governments with a president that has been named by you and not by a military junta, you control the government all the way through its whole administration. The government doesn't have a monopoly on making the law because part of it comes in from the common-law sector. Some is dictated by parliamentarians, but parliamentarians are controlled by their constituents continually and have to go back and be re-elected, not on the basis of party lists but on their popularity and voting records. Some is the product of executive decrees or rules that are supervised continually by government bodies. There are OMB regulations about this; you have cost-benefit analysis; you've got hearings; you've got comment and notice periods; you've got a totally free press which we don't have. All the credit of our press is controlled; all of it, 100 percent, is controlled by government. Sixty percent of advertising is controlled by government.

All the institutional mechanisms whereby people can say to the government, "Yes, you are ruling according to our best interests," are not in place. And therefore, all the mechanisms to be able to govern people and indicate to them that the content of the BGS paper is really what is good for them are not in place either.

How do you break the fact that an oligarchy does exist? It's not always the same one, it varies with each election. The oligarchy which is now governing Peru is not the same that was governing Peru five years ago nor necessarily the same that was governing Peru 12 years before even the military government. There might be some overlaps, but oligarchies change. The fact is that government power nearly means absolute power in Peru, and you're not going to be able to break that absolute power unless you're able to muster the will of most of the population. And the population that, by definition, suffers most and is most excluded by all of this form of rule making happens to be the informal sector.

If one believes in democratic institutions, or even if one believes in revolutions, I don't know how you're going to make change without the majority of the population that is most mistreated by all of these problems. All miscarriages can also be controlled by the fact that you have democratic rule making to allow you to adjust the process as you go along.

You see, one of the interesting things about the studies we've done in terms of how rules are made in Peru is that in effect, all of Peru votes against oligarchies. The reasons given for each of these rules which we've criticized as we've gone through the history of the rules being made include the fear of anarchy, the fear of speculation, the fear of abuse and the fear of monopoly. Until you are able to indicate, in relation to each rule, that these rules do nothing about anarchy or abuse but that they impede the informal sector, they will continue producing these rules. Until you're able to bring through the fact that monopolies and abuse are created by these rules and not the other way around, there's no way you're going to stop this kind of rule making.

The only way to do that is to discuss each rule as it's being made. Not the policies that the governments promise, but each rule as it's being made, so that you can gather popular support for it. And that necessarily involves changing institutions and specifically those that relate to both rule making and accountability of government officials to the population.

MR. SPILLER: I believe that the work that de Soto and his colleagues have been doing is clearly the most interesting in development economics. I have some problems with the politics, but that's not of much concern to me right now.

What the work by de Soto stresses is that the problem of development is not that we need investment, it's not that we need more roads built or that we need to spend more money in education—all good things, but those clearly are not the source of underdevelopment. Instead, what de Soto in his fascinating work has shown is that the problem of development is the lack of a certain infrastructure. Not the physical infrastructure, but rather the legal infrastructure. Usually there is too much or too little, and either excess or default is what has been retarding development. In a sense, this has been the common thread of development problems across countries.

The case of Peru and development of such a huge segment of excluded individuals is interesting because it provides us with an extreme case in which to see the role of these institutions in retarding growth. Essentially developing countries are characterized by first, heavy restrictions on foreign trade, and second, these same restrictions have created rents that are distributed, via the creation of different types of rules and regulations that restrict trade within countries.

The case of Peru is perhaps extreme, but you don't have to go to Peru to see the importance of those rules and restrictions, which are based clearly on the existence of foreign trade restrictions. In almost all countries that you can think of, these rules and regulations have retarded growth, and the slowdown in growth has created more rules and regulations which have further negatively affected growth. In Peru, the point was reached where there was no other way but to let these excluded people arrange their own lives. In other countries where this situation has not been so extreme the excluded have been either repressed or regulated as well. There are interesting cases (like in Uruguay) where the government has actually tried to regulate street vendors and provide them with some rents as well as restricting competition among vendors.

I have also found extremely interesting how the de Soto team stresses the issue of entrepreneurship. The problem of our countries is not one of lack of entrepreneurship. Usually, however, we don't think there are very many entrepreneurs. The reason for this conflict is that the amount of restrictions make it more profitable for entrepreneurs to devote their time to obtain rents from the political system rather than from productive economic activities.

However, the beauty of the informal sector, and the beauty of the work that de Soto has done, is that it shows how entrepreneurship flourishes when it is allowed to develop. I find this important because in the few instances that I have talked with political decision makers in South America, trying to convince them to liberalize trade, the usual question is, "Well, what can our country export?" And clearly I don't know, I'm not an entrepreneur. I can't imagine what this country can do, but certainly they could do things, if they are allowed to develop free of restrictive regulations.

And here we have very interesting evidence about the extent of entrepreneurship. That evidence also can be obtained in other cases; for example, we do some study of the rise of new industries following the introduction of trade liberalization in some countries. You will see industries that did not exist before. I have just finished a study on the Uruguayan trade liberalization experiments. While it has been a relatively minor experiment, still the whole set of new industries that have developed and that are now competitive in the world market is impressive. Thus, de Soto's emphasis on entrepreneurship is most welcome.

MR. WALLACK: I have a brief question and I'd like to direct it first to Professor Payne, and then I'd also like to hear Hernando de Soto's reaction.

Your description of the evil intentions versus the good intentions gone awry is a very neat description, but it doesn't approximate reality. Often, the worst intentions by policymakers sometimes give good results, and we also know, sometimes the best intentions give terrible results. And both of those occur simultaneously.

So the issue, then, is not descriptive, i.e., what's the problem. The issue is what are the criteria for deciding what are good rules or bad rules. And I'm curious, since you said the question is we've got to look at ourselves and find out what our intentions are, what would some of the criteria be in the case of Peru or in the case of any other developing countries where there is the problem of legal norms, to decide if a rule is good or bad? And is it done case-by-case or can a set of them be determined?

MR. PAYNE: I didn't mean that we should analyze our intentions that much. To the contrary, my point is that we often suppose that because we are advancing a policy with good intentions, that is sufficient. My point is that any time you are recommending that the government act, you ought to develop some sense of all the things that can go wrong with what you're proposing—something like, as we have come to do in this country, an environmental impact statement. If advisors had to submit, along with their proposed reform, a list of the things that can go wrong with the policy over the next 100 years, I think it would make us all a little more sober, more careful about what we try to implement.

In terms of the specific things to look for, I can suggest a few points. First, one of the flaws in government policy initiatives is their longevity. That is, they may be focused to deal with a problem that exists now, but that at some future date won't exist in this form; or the agency or whatever we create gets transformed in the future.

I'm thinking of things like the windfall oil profits tax in the United States, for example, which at a certain point in time seemed to address a very large problem, but then in a few years after windfall profits vanish, the legislation continues.

So, one of the things you can do and maybe should do in announcing policies is to try to specify their termination, and how they terminate, and why they should terminate, and that they should terminate at certain points, either in terms of years or some other definition.

A second point: One of the reasons why policies wind up being counterproductive is that the scope of what you are trying to do is so large, so broad that it exceeds the limits of your imagination. For example, let's take rent control. You're thinking of a case where a certain type of tenant is being abused by a landlord, only it doesn't occur to you to think of all the other kinds of landlords and tenants that there may be. Yet you're passing a rule and trying to enforce it for all of them, so you wind up with policy of much broader scope than you intended.

To deal with this problem you need to think of ways to reduce the scope of policy initiatives. One suggestion is decentralization. This solution has not been mentioned here yet, but I believe it is one that Hernando would support: the idea of breaking down government into smaller, more discrete units that handle smaller segments of some problem. Regional and municipal governments can reduce the scope and keep policies from reaching beyond what the promoters of the policy are attempting to do.

MR. de SOTO: I think Jim's comments are very appropriate, as is Mr. Wallack's question on good intentions. Obviously, you can't judge laws on good intentions because nearly all laws have behind them a good intention, such as we want to protect the shoe industry, or we want to create an automobile industry in Peru. So they all have good intentions.

The problem is that they may have, apart from benefits, a lot of costs. So how do you, in a country that produces 111 rules a day, make sure that all the costs and benefits are taken into account. The only way you can do that is by transforming the system. And as Jim says, you have impact statements when it comes to environment, and that's why we talk in the book about cost-benefit analysis. That all rules that relate to economics, like in your country, that come from the executive branch should be submitted to cost-benefit analysis.

Now, you may say well, that's extremely complicated, but it really isn't that complicated. All it means is just allowing that any third party who feels he or she is going to be affected to have a chance to complain, or a chance to make their case. And some of these things can be done without a lot of mathematics.

What's interesting of course is that it not only works in your country, but it also works in the informal sector of my country. We have studied how these extralegal norms, the law of the informal sector, is made. For example, in the organizations of the young towns, people are organized by blocks. In each block, each family has a vote, and each vote elects a representative of the block. The representative of the block in most of these organizations enters into a general assembly. The general assembly elects a secretary general; there is one secretary for sewage, another for water, for electricity, for finance, for corrupting the police, whatever. There are different departments.

And all rules, which are after a while written down, go through democratic discussion. When somebody says we need a rule to protect the neighbors from the dogs, somebody comes up and says well, look, dogs are necessary for my security so I will not do this unless we put up funds to have a police force of our own; they do exist, of course, informal police forces. In other words, democratic rule making is nothing new to Peruvians. It's new to formal Peruvians.

It is interesting that in the last 15 years or 20 years in Peru, I have only once been able to vote for mayor as a formal citizen. But the informals vote every two years for the secretary general of their organizations. There's nothing culturally alienating about democracy to most Peruvians. It's not a cultural problem, it's an ideological problem of the formal sector. The informal sector is organized democratically.

Economic impact statements or the open discussions of rules to make sure that they really do fit all intentions, are really the solution. The question is how do we do it. At the national level, of course, rule-making procedures like yours make a lot of sense, but in some other cases, as Jim says, you have to decentralize and kick these things downward or deregulate, which means privatize certain things so that discussions take place at other levels. And then, of course, try to simplify.

But democratic rule making is the crucial thing because as we have looked into the history of Peru over the last 30 years, there have been I don't know how many administrative simplification commissions. We have had commissions I think coming in from A.I.D. and from different other countries and from world organizations. They have simplified, for example, legislation in the fishing industry, and they really cleaned it up in a year or two. Then three years later it's all back in place. Unless you control the source, which is how rules are made, all these good-intention laws that produce bad results will continue coming forth.

And to give you an idea of how reasonable this can be if you allow the informal sector to participate, take the case in the BGS paper which talks about the problems with financial market policies which controlled interest rates. Well, if you bring the informals in, many of whom at the level of street vendors pay literally—as I think Michael Farbman very well knows—something like about 10 percent a day, and you tell them that the official going interest rate will no longer be 80 percent, which is below the inflation rate in Peru, but it's now only going to be 250 percent, your formal sector—about one percent of the population which is the one that has access to credit—may not like it but all your informals will consider 250 percent really cheap, as if you're going downward.

So if you start democratizing decisions you will get a lot of the consensus of the country going for you. It's when interest rates are left only to the Central Reserve Bank and when legislation pertaining to that is not openly discussed that your so-called oligarchies come into play and start making low interest rates seem popular instead of antipopular, which they are.

MS. SOOS: I would like to ask Mr. de Soto a question about the relationship between economic models and democracy. I've long been intrigued by the notion that economic pluralism may be a prerequisite for political democracy. In the Jeffersonian democracy model, property rights was listed. When Jefferson first wrote the constitution for the state of Virginia, property rights were among the inalienable human rights that were listed, but this was dropped from the U.S. Constitution because there was not a consensus on it. But without a defense of property rights, you really cannot have a broad-based stable economic structure and it's easier for an elite to subvert a system to its own ends.

I would like to ask him if he thinks a broad-based economic protection of rights would help promote the chances for political democracy by creating a broader middle class which can then forge a national consensus. The political parties generally, in the United States are within this broader middle class segment.

For example, your illustration of the time it takes to register or to obtain title to property, six years plus, do you think that it would also take a member of one of the ruling business families that long to obtain title to a home or a piece of property for a factory?

MR. de SOTO: Yes, it would seem that there is a very strong connection between economic rights and democracy. One of the interesting things about the emergence of the informal sector, the urban informal sector, in Peru is that one of its strongest points is the protection of property rights; the first duties of—whether it's a committee of bus drivers or truck drivers or whether it's a pueblo holding organization, whether it's ambulatists—is the protection of property rights. An extreme violation of property rights can even be punished by death. They are very strong about property rights.

All their organizations that deal with government have as their first objective insuring their properties, making sure that it is a right. As people begin to get property they will identify with all the formal sector that already has property; on that basis they will create a wide consensus to defend property and get rules that are beneficial to property, rules that facilitate the transaction between people who have properties, and rules which cut, as I think Ms. Landa would say, the transaction costs between the different members of the market economy.

The problem for the moment has been that for poor people to accede to property is a longer process. It's a much more complicated process than for wealthier people. For example, when I came back to Peru about seven or eight years ago and I bought my house, I think I finished all my legal transactions in about two or three weeks. I myself probably took no more than five hours to purchase my house and have clear title to it. But it's obvious that the law affects different people in different ways. That is the law that refers to the greener areas of Lima and that refers to the places where I can buy because I've got sufficient money.

If you're poor in Peru, your only access is to the sand dunes. The sand dunes belong to the state, and the government, for access to those properties, has a series of regulations. These regulations oblige you, if you're a group of families that want a sand dune awarded, to go through red tape for, as I said, six years and eleven months. It involves 207 bureaucratic steps, and you have to visit 52 government departments in the whole process. So obviously, the law does apply in my country very differently to rich and to poor or to wealthier, even middle class, and the poor. And the only way you can find this out is by going in and digging it up. But that's the way it is.

Now what we're trying to do in Peru is convince the formal private sector that it is absolutely necessary that they come out in representation of the informals because it's the only way that their property rights will be secured. Now we've been saying this, as A.I.D. knows, for about three years; we've been putting ads in papers, we've been criticizing them, we've been bullying them, and generally to no avail. All that has happened so far is that we haven't been invited to their conferences, we've never been speakers there.

But something interesting happened in the course of the last two months in Peru; that was the nationalization of banks, or what remained of private banking, by Garcia. And what was interesting was that Garcia nationalized the banks in the name of the informals. He said he was nationalizing them to be able to democratize credit because the private banks weren't giving credit to the poor people. Which from our point of view represented a victory because both Garcia and the extreme left had been saying that the informal sector members are not entrepreneurs; that we are trying to see a capitalist class where none exists; that they are simply unemployed laborers. But by giving them credit he is acknowledging that they are entrepreneurs, so we consider that a step ahead. Naturally, that step ahead has been at the expense of the private bankers.

So what we told the private bankers in open letters to them in editorial pages and in communicados in newspapers was that if they had been able to identify their own private property and interests with those of the poorer people, Garcia could have never expropriated the banks from them.

In one of our interviews—most of our information for the book, *El Otro Sendero*, at the ILD was obtained through interviews that anthropologists showed us how to conduct—with 80 of the most prominent informal entrepreneurs of Lima, we asked a question which was, "Are you of the private sector?" and the reply in 79 out of 80 cases was, "No, I'm not of the private sector." Then we asked them, "Are you of the public sector?" to make sure we were on the right road, and they said of course not; the public sector is government. So we said well then, "Who is the private sector?" and the reply was "those up there," the oligarchy, in other words.

We told the entrepreneurs that their private property was affected, and that if everybody had identified banking property with their own property the nationalization could not have occurred. We've got all the provisions in our constitution to defend private property that you have in your constitution. It's all basically there. What really defends private property is that everybody has got a vested interest in private property. And that doesn't occur in Peru because the poor are defended in much a meeker and weaker way than the richer people. So obviously, if the law can be applied more equally in real terms to all, the defense of democracy will be more feasible in Peru.

MR. GALLAGHER: I think that the work that you did, Mr. de Soto, is very useful, and I think the analysis includes the right actors, namely, the mercantilists, the state and the informals. However, I think that the work could have been improved a little bit by considering the incentives and the objectives that the different actors face. I don't want to say that I know what those are, but I think if we had considered them a little further, both you and Mr.

Payne may have come out with some slightly different conclusions or outcomes.

For instance, if we considered the incentives and objectives of the state and of the mercantilists, Mr. Payne may not have been able to conclude that the intentions of a lot of laws were probably good and that the laws went awry. It doesn't seem possible that so many bad policies which create economic rents for so few people in so many Third World countries could simply be so many good laws gone awry.

Also, Mr. de Soto, in your paper, your seeming implication that the president should go to the 8.5 percent of the population that would benefit as opposed to talking to the 1.5 percent of the population that would be hurt seems to say that the numbers are important. But that's probably not true; there's probably a good reason why he goes to the 1.5 instead of the 8.5. Our quest for democracy and all is merely a good outcome, but it doesn't explain why it's not there. I'm not sure what the strategy then must be.

MR. de SOTO: Thank you for your interesting comments. I happen to think that this difference between the 8 percent in one case, which was I think the one referring to spare parts or the transport industry, compared to the one-tenth of one percent is important. We saw it clearly in our case when it came to the titling law. The tradition in Peru, for example, regarding housing has been that the politicians have always preferred direct participation in the building of homes in Peru because it allows them first of all to get photographed and then to get a bronze plaque saying that under this government they built 10,000 rooms or whatever it is; that's a way to show that you're being busy politically, that you're doing things for poor people.

When we came out against this long tradition by saying that the government could do much more by awarding the right kind of property titles and by making access to real estate much easier—in a country where only three to four percent of all the territory can be used for agricultural purposes and so one abundant resource of the country is definitely our sand dunes—we were able to obtain the backing of 300,000 informals in one month.

When we opened our offices in the center of Lima to ask for the support of those people who believed in our draft law, we obliged Garcia three weeks later to put out the kind of law we talked about. Not only did it oblige Garcia to put out a law that said private property titling should be done efficiently and quickly, and that this was a prime objective of his government, but the people who were responsible for administering it, the Communist municipality of Lima, became the fastest and biggest private property titlers in the history of Peru. This occurred in spite of the fact that it went against their party statutes, in which they condemn private property as being decadent and especially motivating selfishness.

But I think that in the measure in which you are able to tell—and in this sense the works of Buchanan or the neoinstitutionalists or public choice are very interesting—if you can convince politicians that they're going to get more votes, or in the case of spare parts 80 times more votes by allowing spare parts to come in without tariffs, or that you're able to tell Garcia that a puny little institute can get 300,000 signatures to support private property, the fact that you can do that is very important for politicians because they are motivated by votes. If they want to stay in power they've got to do what people want.

So I think that the reason why the one-tenth of one percent in one case predominates over the eight percent, or why the 4.8 percent of unionized workers in Peru predominate over the 60 percent of informals is because the 4.8 percent in one case or the one-tenth of one percent in the other are organized. They're organized and they can get their vote across. The only reason why oligarchies are able to enforce their will over a large majority is that they're organized; the rules work in their favor. That's why it's very important to keep on helping informals organize because they're the best constituency for democracy and a market economy in our country.

MR. CAHN: I coordinate A.I.D.'s private sector programs for Asia and the Near East, a slightly different part of the world with different cultural and political traditions but nevertheless very similar with respect to the size and importance of its informal sector.

I think that your paper has made a contribution, a great contribution, in demonstrating the relationship between the rule of law—both formal statutory law as well as administrative rule making and administrative practice—and economic growth and both economic and political liberty, particularly in its implications for mobilizing that great part of the economy which the informal sector represents.

However, at any point in time, we are all dealing with the status quo. The status quo at this time is very much as you describe it in your paper. A.I.D. currently is subject to many pressures from people who have read *El Otro Sendero* and other of your writings, and perhaps have misinterpreted their implications. We are being importuned not only by them but perhaps by our own good motives of wanting to assist the informal sector, to call attention to it, work directly with it, see what we can do to help.

Your paper here points out, I think, that the best thing that we can do to help is to stimulate policy changes of the sort that will provide a basic rule of law, particularly with respect to property rights including intellectual property rights and contract rights, for the benefit of all including the informal sector. However, we've been importuned to take other steps such as in the credit areas that you mentioned or in working directly with entrepreneurial development at the microenterprise level.

My concern is that by calling attention to the informal sector, we may be doing it more harm than good. Currently, part of the status quo is that the informal sector represents a tax exemption and a regulatory exemption in most developing countries. The powers that be see the very high transactional costs in dealing with it and don't see it as a means of increasing their power and their wealth or the wealth of their government coffers.

If we demonstrate the size and value of the informal sector and raise its visibility, we may bring it to a point where that zone within which the informal sector may operate freely, given the current policies which are inimical to their development, actually becomes smaller. We may in fact encourage governments to impose more regulation on the informal sector, rather than freeing up regulation for all. Instead of making the graduation from informality easier, we may be making it more difficult and lowering the point at which it takes place.

I wonder if perhaps the best thing we can do for the informal sector—besides attempting to change the policies which you are trying to change—is to leave it alone and let it operate during the time that these policies are still in existence.

MR. de SOTO: Thank you for your question; it's obviously an interesting one. I've never thought of it outside the context of Peru, and from an A.I.D. point of view I really don't know what to say. But maybe I can tell you what we thought of when the same kind of issues were raised among ourselves before we undertook both our studies and our activities in Peru.

We did raise the visibility of the informal sector, and we raised the visibility of the informal sector with the purpose of indicating to politicians that they had a constituency that was entrepreneurial and that would respond not so much to charity as it would to entrepreneurially favorable legislation. We also tried to indicate, that legislation affected them in a very different way from how it affected us, the formals. So it wasn't a question of saying well, now you can register property quickly, because that you can do in Peru provided you're a formal. You can't register property quickly if you're poor. You can get credit quickly if you are formal, but can you get credit quickly if you're poor?

And we started indicating that the problems that the informal sector has are not the same ones that a formal sector has in Peru or even in a country like the United States; you necessarily have to employ the type of skills that I'm sure Ms. Janet Landa has, which are those of the anthropologist or the sociologist. There are things which are not obvious until you dig them up. And therefore, one of the things you have to do is find out where this informal sector is, how big it is, what its interests are, what its constraints are, what the institutional constraints upon it are, and what it would need to come from the informal to the formal state.

In many cases, when you're digging up this kind of information you get the kind of information whereby you start silencing the people who believe that you do not know what you are talking about. For example, in the case of Peru as we proceeded in our studies, we started finding out that arguments the informals don't pay taxes and therefore should not start complaining until they start paying taxes, are not true. We found out that 40 to 50 percent of the total tax collected by the state in Peru is composed of the gasoline tax. Those are the total tax returns. Forty percent to 50 percent comes from gasoline tax, and since 95 percent of transport in Peru is informal, in fact the informals were already paying a great amount of the tax.

We started finding out that income tax is only paid by 2 percent of the population, and it is a very poor source of income for the state. Most of the tax actually came from indirect taxation where the informals are as big a factor as the formals. And moreover, there were other specific or excise-type taxes which the informals paid way in excess of the formals. One example is the street vendors. In Lima, to be able to sell on the street you have to pay a tax called *la sisa*, which comes from an old French tax called *la sise*, which is simply the right to be on that street that day, and everybody pays it to the municipal police.

And we found out that street vendors pay more taxes in the form of *la sisas* than we formals do on property tax all throughout Peru. Just the informals in Lima provided more tax return to the government than all the formal private property tax of Peruvians throughout the country to the state. Then you also have inflation tax because the informals have to carry a great amount of cash; they have to do their transactions in cash, as a result of which the informals actually pay more cash. So if you brought the informals into the formal economy you would maybe even be reducing the returns of the state and you'd be doing the informals a favor.

As the facts come in, you start doing justice and justice is generally a good thing, so you're taking the right kind of decisions. I'm sorry, it might be a romantic reply, but I do think that truth doesn't hurt.

MR. PANSINI: When Warren Weinstein first loaned me Mr. de Soto's book, what leaped off the cover was the title, *El Otro Sendero*, which I took as a reference to El Sendero Luminoso, Peru's major armed revolutionary group. I understood, or I saw in much of what I read, that the growth of Peru's informal sector was also a revolution that was taking place. As such, one of its essential features is that it is not able to be regulated by the formal sector, be that the bureaucracy or the government's executive branch. Would you care to comment?

MR. de SOTO: I'm afraid I'm going to disappoint you about titles and all that. When we tried to choose a title, I talked with a few authors and they said make sure the title is interesting. So in a country where there is the Shining Path, "Sendero Luminoso," which among Peruvians is called just "Sendero" for short, when you say *El Otro Sendero* which is the other shining path, you've got an interesting title.

Second, yes, in my country those people who are talking about change are, in effect, usually the extreme left. I mean, 32 percent of Peru votes communist. I think this is important to keep in mind. The whole coalition of small leftist parties in Peru aren't Philippe Gonzalists or Mitterrand type social democrats; these are varying forms of communists, and they're the only ones proposing change at this moment. They may have a very good chance to actually get in and do it legally from central government and win elections.

A little bit of what was behind the idea of *El Otro Sendero* is taking the most radical of their manifestations, which is the shining path, and saying there are other peaceful ways to change. These other peaceful ways to change aren't led by an elite with imported ideas; it's the majority of Peruvians who have chosen the road that is entrepreneurship, through the extralegal norms that indicate respect for individual rights which are reached in democratic assemblies. So there is another road.

There was a message behind it. The idea was that it be a message that travels, that becomes efficient. That's what is a little bit behind the title.

And that leads me to part of the question that David Cahn asked before and that I didn't completely respond to but which I think can tie up with yours: Shouldn't we leave the informal sector alone? Of course as a Peruvian, I don't think so because there are limits to the informal sector. The informal sector, if you care about development, is doing what it can on its own; but until the laws are generalized and well enforced—especially as long as there is none of this facilitative law, good property rights and good contracts to reduce transactions costs—there's an enormous amount of effort and frustration required to achieve what at the end is really very small results for a great effort.

There are very good humanitarian, philosophical reasons for getting in there and helping. You can make a difference by putting in the right institutions. I think one of the things that most illustrates this is property title. We know that the possibility of somebody in the informal housing sector being evicted is minimal, it really is very small; according to our calculations at the Institute only 2 percent of people who are actually occupying land in Lima have any danger whatsoever of being evicted. Yet the moment you give the other 98 percent title to their homes, the incentives to invest rise nine times. So you can do a lot by helping the informal sector providing you do it right.

There are also good political reasons for doing so, I would think, in terms of U.S. foreign policy. Consider that 4.8 percent of our working population is unionized. You put a lot of money in through the unions to fight communism and you've got 60 percent of the population or more, or maybe 70 or 80 in fact that is in the informal sector. The communists are really putting their money there more than in the unionized sectors because they did their figures a long time ago. There might be a lot of good political reasons for being in the informal sector.

One of the reasons I'm in the informal sector, of course, is because there's a practical monopoly of communists in the informal sector. It's been a long time since they managed to get rid of their old Stalinist tendencies. They've accepted that microenterprise is a characteristic of the Peruvian proletariat and, just like Hungary and Gorbachev, have learned to tolerate it. So they have decided to tolerate informal activity up to a point and concentrate on taking over foreign affairs and the rest of the small and medium enterprises. You can have communism with a large informal sector as well.

3

Janet T. Landa

Underground Economies: Generic or *Sui Generis*?

The central conclusion of the preceding paper by Hernando de Soto is that Latin American legal institutions discourage entrepreneurship. This is because of the costliness of compliance with the labyrinth of rules and regulations associated with existing Latin American "mercantilist" institutions. As a consequence, many low-income individuals in Peru, for example, are forced to exit from the formal sector and enter the underground or informal sector. Within the informal sector, the "informals," who are primarily the indigenous population and representing some 60 percent of the total population, have created for themselves "extralegal norms" as a substitute for the law. According to de Soto:

> We have found no dictatorships, or mafia-type organizations, no kolkhoz or ayllus, but rather individual or family ownership, and rules that attempt to create fair competition through extralegal norms for property, contract rights and torts.

These extralegal institutions created by the informals are

> eminently democratic and the economic system they have devised is a nondiscriminatory market economy. Therefore the informals are the largest, as yet unrecognized, totally nationalistic constituency on the continent for participatory democracy and a market-driven economy.

However, the lack of facilitative laws means that for the formals remaining in the formal sector, the costs of compliance with legal rules remain high. As for the informals, operating outside the law, they "have little choice but to associate themselves, almost tribally, with close family members and limit themselves to artisanal production and small firms." Thus the overall productivity of the Latin American economies is lowered.

The empirical findings led de Soto to challenge existing theories or hypotheses, which in various degrees serve as the bases of current Latin American developmental policies—cultural hypotheses, Marxism-Leninism, dependency theory, and liberation theology—as being inadequate in coming to grips with the cause of Latin American underdevelopment. The key, according to de Soto, "lies in adopting those legal institutions which make democracy and markets work for everyone and whose roots are found among Latin informals and Western nations." De Soto's important empirical finding that facilitative laws are necessary to promote entrepreneurship and the development of markets is consistent with the New Institutional Economics (see the section "Implications of Theory for Policy" below).

This paper has three main objectives. First, it will provide evidence that the existence of an informal sector where entrepreneurs themselves create extralegal norms is not unique to Latin American countries but is part of a more general phenomenon found in less developed countries (LDCs) where the legal framework is not well developed. The most conspicuous examples of the phenomenon are found in trading sectors dominated by foreign ethnically homogeneous middleman groups (EHMGs): the Chinese in Southeast Asia, the Indians in East and Central Africa, the Lebanese in West

Africa, and the Jews in Medieval Europe and elsewhere. These EHMGs have provided themselves with informal (cultural) norms of behavior which function as substitutes for formal contract law. Thus, my initial answer to the title of the paper is "generic."

Second, it will provide a theory of the EHMG as a low-cost club-like institutional arrangement for the enforcement of contracts. And third, it will examine some implications of the theory for answering questions such as: (a) Are underground economies nondiscriminatory? and (b) How can we encourage a greater supply of indigenous entrepreneurship in LDCs?

Discussion of these topics is organized in four sections. The first discusses the concepts of underground economy and the informal sector and suggests an alternative concept of a "shadow" economy to describe a special kind of underground economy. The second provides empirical details of how the EHMGs in Asia, Africa, and Medieval Europe have coped with the problem of contract uncertainty. The third provides a theory of the EHMG that integrates several key concepts in the various social sciences—economics, law, game theory, sociology, and anthropology—into a broader transaction cost framework. The fourth and concluding section examines some of the implications flowing from the theory for clarification of certain issues arising from de Soto's paper and from the literature on the economic development of LDCs.

The Informal Sector, the Underground Economy, and the Shadow Economy

Although de Soto emphasizes the existence of extralegal norms as a key characteristic of the informal sector, he does not provide a definition of the informal sector that captures that essential feature. According to de Soto, an "informal sector is composed of those people, who, although pursuing legal ends, such as building a house or operating a business, have not met all of the legal requirements to do so."

Given this definition of the informal sector it would be better if de Soto employed the more accurate concept "underground economy" rather than the concept of "informal sector," especially since de Soto uses the two concepts interchangeably. This elusive concept of informal sector is used by development economists and anthropologists to describe different activities within the informal sector (compare Hart, 1973 and Mazumdar, 1976; Bromley, 1978 and Trager, 1985). But so far, none of the definitions of the informal sector have identified the institutional framework created by the informals as a key characteristic of the sector. In contrast, the term "underground economy" is more narrowly defined to describe an economy where participants violate certain legal rules. Thus "for some experts, underground economy represents almost exclusively the income that is not reported to tax authorities, regardless of whether such an income is, or is not, measured by national accounts" (Tanzi, 1982, p. ix). But, like the concept of informal sector, the notion of an underground economy does not emphasize the importance of extralegal norms embedded in the underground economy. I therefore propose an alternative concept—the shadow economy—by tracing the origins of the concept of informal sector to the work of P. T. Bauer, a pioneer in development economics.

Lord Bauer (1984), reflecting on his contribution to the early post–World War II development literature, noted that the dynamic effects of the activities of traders were largely ignored by development economists. And when not ignored, middlemen were looked upon with disfavor. But Bauer's work

> exposed the underlying flaws in familiar proposals and policies for restructuring the trading sector in LDCs. These measures ranged from restriction of the number of traders, and the enforced elimination of particular stages in the chain of distribution, to large-scale state support for cooperative trading and to the suppression of private traders and their replacement by state trading organizations (p. 38).

The adoption of these policies "had the unsurprising consequence of restricting the opportunities for producers and consumers and of entrenching inefficiency in the trading sector" (p. 38). Unsurprising to Bauer because, contrary to the thinking of early postwar development economists, he saw middlemen/trading activities as playing an indispensable role in the economies of Southeast Asia and other LDCs that he has studied. The traders link the indigenous producers with ultimate consumers and brought about a "more effective interregional and intertemporal allocation of output" (p. 37). Lord Bauer continues:

> My observations and analysis of trading activities and arrangements gave rise to much subsequent work by economists and anthropologists. Professor Walter Elkan has gone so far as to suggest that this early work pioneered recognition of the presence and significance of what has come to be termed the informal sector in the LDCs, and initiated the study of its economics.

Thus, if we trace development of the informal sector literature, it is clear that *trading* activities inspired the emergence of the informal sector concept. The trading sectors in Southeast Asia, in East and Central Africa, and in West Africa are dominated by the Chinese, the Indians, and the Lebanese traders, respectively. As shall be described, these EHMGs brought with them to the host countries "ethnic-specific capabilities" (Dotson and Dotson, 1975, p. 568), including the capacity to create for themselves rules of business based on their own cultural/legal traditions, as substitutes for formal contract law. Because of this capacity, these ethnically homogeneous middleman groups (EHMGs) can be said to operate "in the shadow of the law" (Mnookin and Kornhauser, 1979; Galanter, 1981). I shall call such type of underground economy a "shadow economy."[1] From this definition of a shadow economy, it is clear that:

(a) A shadow economy is a subset of a more inclusive informal sector in that all participants in the shadow economy are also participants in the informal sector, but not all participants in the informal sector are necessarily participants in the shadow economy.

(b) There is a continuum of underground economies with pure types at the extremes of the continuum. At the one extreme are the shadow economies created by the EHMGs; at the other extreme are the illegal underground economies created by Mafia-type groups. De Soto's underground economy would fit somewhere in between the two. But all three types of economy are similar in that the participants have created their own rules for facilitating their activities.

(c) Attention is emphatically directed by the concept of a shadow economy to the importance of efficient laws and institutions for encouraging entrepreneurship and economic development. The very existence of extralegal rules of the game points to the lack of a well-functioning, efficient legal system for the larger society in which the shadow economy is embedded. The extralegal rules of the game thus perform a crucial gap-filling function.

The Shadow Economy of the EHMG: The Role of Trust, Reputation, Cultural Norms, and Sanctions

This section provides evidence that ethnically homogeneous middleman groups (EHMGs) function as "clubs" for the enforcement of contracts. We shall describe such clubs formed by Chinese middlemen in Southeast Asia, Indians in East and Central Africa, Lebanese traders in West Africa, and Jews in Medieval Europe and elsewhere.[2]

Chinese Middlemen in Southeast Asia. The marketing of smallholders' rubber in West Malaysia is dominated by Chinese traders who function as middlemen between smallholders, largely from the indigenous population, and overseas buyers (Landa, ch. 3, 1978, 1983). In 1967 there were 2240 licensed rubber dealers in West Malaysia. Members of the middleman group are arranged in a pyramidal marketing structure with division of labor among the different levels of middlemen. Village dealers, about 1,500 in number, buy rubber sheets from smallholders and grade and sell them to town dealers. Town-dealers, numbering about 667, process and smoke the rubber sheets prior to resale to packer-exporters. About 63 packer-exporters, located in ports such as Kuala Lumpur, Penang, Malacca, and Singapore, sort, regrade and pack the rubber into bales for export to overseas consumers. In addition to these groups, there were the remillers and the commission agents. In Singapore there were at least 72 rubber dealers of which about 37 were packer-exporters. The rubber dealers occupy an important position in the economy of Southeast Asia, given the economic significance of the rubber industry.

A closer look at the Chinese middlemen in Singapore and West Malaysia reveals the existence of a tightly knit, ethnically homogeneous Hokkien-Chinese group. Within the group, six clans from Chuan-chow and Yung-chung in China's Fukien province—the Tan, Lee, Ng, Teh, Lim, and Gan clans—dominated the marketing network. The Hokkien ethnic community is the most wealthy and powerful of the five major Chinese ethnic groups (Hokkiens, Teochew, Cantonese, Hakka, and Hainanese) by virtue of their dominance of the smallholders' rubber trade. Interviews with a number of Hokkien rubber dealers in Singapore and West Malaysia reveal the importance of kinship and ethnic ties as a basis for establishing mutual trust and the informal sanctions that operate to enforce contracts.[3]

According to Dealer 1:

> The way we Chinese operate in the rubber trade is that once a verbal agreement is reached, it is expected to be kept; it is based upon 100 percent mutual trust. Written legal contracts for us, are only a formality. We make a big transaction over the phone and sometimes we sign the contract, maybe a week later. But tomorrow, due to price changes, there may be profit or loss of $1,000 or $1,000,000; but the transaction has already been made over the phone and must be kept by both parties. It is a matter of trust, very similar to operations in the stock market; once transactions are closed, one doesn't change one's mind. If we know that a trader is well known and reliable, we are prepared to do business with him. What Chinese call *kan-ch'ing* is very much also a matter of *hsing-yoong* (trust). If I have confidence in a person, then I develop a *kan-ch'ing* relationship with him. If I have *kan-ch'ing* with a person, I also trust that person.

According to Dealer 2:

> Because of the risks involved in advancing money without security, based purely on trust, we tend to trade with those whom we trust; they are often kinsmen, friends, people from the same place in China, and those who speak the same dialect. Because of the longer association of Hokkiens with each other in the rubber industry, we find it easier to give credit to a fellow Hokkien because there are ways of finding out the creditworthiness of that person: about his background, his associates, his ethical code and so on.

And Dealer 3:

> Confidence takes a long time to build up, therefore our regular customers tend to be friends, those with whom we have kinship ties and whose backgrounds are known.

The importance of trust in exchange relations was further brought out in a number of statements made by prominent members of the Singapore Chinese community.

According to Yap Pheng Geck:

> Chinese started being clannish. Besides being clannish, they also have locality ties. People from the same place in China club together to help each other. There is quite a lot of mutual help including extending credit to each other. The credit system among the Chinese is a loose system because there are no hard and fast rules. It is based purely on trust or *kan-ch'ing* based on kinship ties and on long association. This mutual trust has been responsible for the collective success of the Chinese. The secret of Chinese success is mutual aid/mutual trust based on surname, family ties, clan ties, and so on. The Chinese have this kinship bond. They club together to help each other. I've seen it in all the Chinese communities I have visited: in Thailand, the Philippines, San Francisco, and New York. This mutual trust means that the Chinese are very good at using credit; they seldom fail. We must not lose this spirit of mutual cooperation and become individualistic. We are individualistic in spirit, but collective in enterprise. If we are on our own, our resources are limited.

Or C.M. Wong:

> In Chinese business transactions which are oral promises, the oral promises are as good as gold because they are based on mutual trust. All the terms agreed upon must be carried out. Once you have made a promise, you cannot retract it.

Beyond the role of trust embedded in particularistic exchange relations, there are sanctions for punishing those who deliberately violate accepted trading practices. In a cohesive Chinese community where dense face-to-face communications networks exist, word gets around very quickly if anyone breaks a trust or promise. The result of gossip is that the offending party will be shamed: he will "lose face." The Chinese are very sensitive to "losing face." As Yap Pheng Geck puts it:

> When a man has been declared bankrupt, usually this means that the man has not been honest about his commitments. He must have played people out. If he had not, even if he had, relations come out. The Chinese also have this peculiar sensitivity: we do not like people with the same surname or people seen with us to go down. If that person is a family friend, the community will say, "What sort of a man are you to allow your friend to go down?" So, I feel an obligation to assist him; otherwise it also reflects on me. We have this peculiar sensitivity that induces us to mutual assistance.

On bankrupting the offending party as a mechanism for punishing those who violate the Chinese business code of ethics, Tan Ee Leong has this to say:

> If a person has promised to sell certain goods at a stipulated price, he must sell the goods even if the price has changed in the meantime. If a person breaks his promise/trust, then he will have to deal on a cash basis. This would be very difficult for a person with no capital or limited capital. . . . When a business fails because of genuine losses, creditors may write off the debt if they feel that he cannot pay, or they may accept composition if they feel he has some means to pay the debt. But if the person has been cheating his creditors, then the creditors will bankrupt him just to punish him.

Yap Pheng Geck puts it in another way:

> Rarely do creditors take debtors to court. Taking debtors to court is a method of last resort, and usually this is done because a debtor misbehaves or has been fraudulent.

The following illustrates a case in which a dealer has been sued in court:

> Mr. X was sued by his creditors. He was unable to pay his debts. To make matters worse, he showed contempt and spite towards his creditors. Mr. Y, a creditor, was very angry with his debtor. He was on a business trip to Hong Kong but flew back to Singapore to attend the court case. The case was initiated by the whole group of creditors. Mr. Y said that the case involved only a few thousand dollars. But he was willing to pay for the trip back to Singapore and then return to Hong Kong to finish his business deal. The airfare plus lawyers fees all added up to a significant amount. In fact he lost more money by prosecuting the debtor. But he did it simply because the debtor did not show respect for the principles of Chinese methods of conducting business. When he could not pay his debt, instead of attempting to remedy the situation, he worsened it by showing contempt for his creditors. In other words, "this man is not suitable to remain in the business community: he does not deserve cooperation or help from his colleagues."

Other researchers on Chinese middlemen in Southeast Asia have also emphasized the importance of mutual trust and the Chinese strategy of particularizing exchange relations as a way of establishing mutual trust.[4] In his study of Chinese traders in South Vietnam during the decade prior to the Communist takeover in 1975, Clifton Barton (1983, p. 49) observed that:

> the most frequent explanation given by Chinese merchants for their success in business affairs was couched in terms of a single characteristic, which in its Cantonese form is referred to as *sun yung*. Chinese merchants were successful in direct proportion to the amount of *sun yung* they possessed. Vietnamese merchants failed to achieve the level of success attained by Chinese traders because they were generally lacking in *sun yung*. Interestingly enough, Vietnamese

merchants generally agreed to this explanation for their lack of success in competing with the Chinese.

Barton explained that *sun yung* means "trust" or "confidence." When a person is said to have *sun yung* it means the individual has a reputation for trustworthiness; his word is his bond. People who cannot be trusted have no *sun yung*. Barton continues (p. 53):

> One of the main contentions of this paper is that the Chinese were able to succeed in Vietnam because they developed mechanisms for generating interpersonal trust and regulating business behavior in the absence of a well-functioning legal system. The Chinese approach to business was based upon verbal agreements relying solely on mutual trust—*sun yung*—backed by informal group sanctions. If a merchant was not trustworthy and reliable, that is, if he lacked *sun yung*, it would be impossible for him to do business. Once the fact that the merchant had failed to honor his word became known, other merchants would simply refuse to do business with him.

The importance of mutual trust means that "economic relations, in particular, were important factors in ethnic identity. And for traders, credit relations were particularly important in defining ethnic boundaries and generating ethnic groups" (Barton, 1983, p. 62).

Similarly, in his study of Chinese crop dealers in Malaysia in 1956 and in Thailand between 1969 and 1974, Peter Gosling (1983, p. 143) also emphasized the importance of trust in credit relations:

> The Chinese attitude towards debt and credit, two sides of the same coin, reflects their acquisitive ethic. Capital can only be made productive by investment, and extension of credit is often the only convenient form for immediate investment of small amounts of capital, with high liquidity. This in turn reinforces the stress on friendship, trust, face-to-face relations and detailed knowledge of the creditworthiness of the borrower because the small size and short duration of most loans, combined with the lack of easy legal provision for chattel mortgages, make most formal collateral impractical or impossible.

How do Chinese dealers transact across ethnic boundaries? In this case, the relations between Chinese dealers and indigenous producers are also based on trust and involve credit as well (Barton, 1983; Gosling, 1983). But as Landa (1976, ch. 3) shows, the relationship between traders across ethnic boundaries is a fragile one. For example, during the racial conflict and violence in West Malaysia during the late 1960s, most Chinese village dealers surveyed had withdrawn credit and dealt with indigenous producers on a cash basis because of the increasing difficulty of collecting debts. Thus, there existed a credit economy within the Chinese middleman economy side by side with a predominately cash economy of indigenous producers.

Because of the importance of trust in exchange relations, information acquisition regarding the trustworthiness of a potential trading partner is crucial. Chinese dealers acquire such information in two ways: (a) directly at dinner parties and other social functions, including information acquired from the numerous Chinese mutual aid associations of which many dealers have overlapping memberships; and (b) indirectly though inferences about the reliabililty of a potential trading partner based on his status or identity, i.e., whether he is a kinsmen, a member of the same ethnic group, or an outsider. This presupposes the existence of a code of ethics regulating behavior of insiders vis-à-vis each other. In traditional Chinese society, the institution existed in the form of a Confucian code of ethics of mutual aid, *pao* (Yang, 1957), which prescribes differences in the degree of mutual aid among various categories of kin: the individual's loyalty is first and foremost to his own kinsmen, then extended to members of the lineage, then finally to members of the same clan in descending degrees of obligation.

Nonindigenous EHMGs in Africa.

Indians in Central and East Africa. The largest single foreign ethnic group involved in the African trade as middlemen in the 1960s was the Indians. The Indians came from India to Africa through their early connections with Arabs and Portuguese, and especially with the British. Because of their historical ties with Britain, they are mostly found in British East and Central Africa. Dotson and Dotson (1968) have provided a detailed study of the

Indians in Central Africa, consisting of Rhodesia, Zambia, and Malawi. The middleman role in Rhodesia and Zambia is dominated by Indians coming from peasant families in the Gujarat region in India. The group is tightly knit, consisting of kinsmen bearing the surname of Patel associated with the Patidar caste. There is a high degree of internal solidarity among the Patidar merchants because of kinship and caste ties. In India, the Hindu caste system is unique in that all members of Hindu society are born into a particular caste for which they have life-long membership and from which they cannot escape. Each caste has its own values and norms. With no option to cross caste boundaries, the Hindu caste code prescribes a high degree of mutual cooperation among caste members. Dotson and Dotson (1968, p. 66) explain why Indians in Central Africa were successful in their middlemen roles:

> Indians are, with few exceptions, ascetic and self-denying; at the same time, they are disciplined to hard and persistent effort toward future goals. The same culture provides them with a normative basis for effective social cooperation in small, tightly knit kinship, caste and locality groups.

The Gujarati Indians are especially prominent in the more profitable wholesale African trade where almost all sales are made on credit. How do they minimize credit default? Unlike the Europeans in Africa, who resort to formal contracts in their business dealings, the Indians use the status of kinship, caste and religion in their dealings with each other to protect against credit risks. With increasing competition from African traders at the retail level, Indian wholesalers are prepared to do business with African retailers, but they fear the risks of credit default. As Dotson and Dotson (1968, p. 84) describe the situation:

> They complain bitterly that extending credit to African retailers is utterly ruinous; but they go ahead and do it anyway, hoping that the number of those who are reliable will increase.

Lebanese Traders in West Africa. The Lebanese traders came to West Africa around 1900, about the same time that the Indians came to settle in East and Central Africa. What accounts for the Lebanese success as middlemen? Dotson and Dotson (1975, p. 589) comparing the Lebanese with the Indians, offer the following explanation:

> Unlike such historical trading peoples as the Greeks and the Jews, neither the Indians nor the Lebanese who came to Africa were typically traders in their lands of origin. In both instances they came overwhelmingly from peasant families, but from peasants who possessed those indispensable "personal and political connections" commented upon by Frankel with traders already established in Africa.
>
> Although quite different in major ethnological characteristics, these two Oriental peoples were remarkably similar in those aspects of traditional culture and social structure that predisposed them to success in business. Both, for example, possessed a family system extended beyond the immediate "nuclear" unit of parents and dependent offspring. The extended family is conducive to successful business entrepreneurship in two ways. At the value level, the strong sense of obligation and family continuity inculcated by it helps to create and constantly reinforce the future orientation that we have described as a shopkeeping prerequisite. Organizationally, on the other hand, the small, tightly knit unit so created provides the foundation for co-operative action, capable of transcending the limitations of either the capital resources or the functional capabilities of single individuals. Particularly when initial resources are small, this capacity gives such a group tremendous competitive advantages over isolated individuals. . . .
>
> Indians and Lebanese came from peasant villages, it is true; but as Orientals they also came from societies in which commerce and trade were anciently established and well understood in principle, even by their peasant populations.

Indeed, the Lebanese came from a society where trade was already well developed in the Muslim world of the Middle Ages. The period of economic development of the Muslim Empire, which began around A.D. 750 and lasted right down to the fourteenth century, was spearheaded by trade and commerce (Rodinson, 1973). The Islamic code of behavior, as codified in the Koran and the Sunnah, prescribes mutual aid and cooperation among fellow Muslims. This ideology provides merchants with a sense of internal solidarity.

Jewish Merchants in Europe and Elsewhere.

Jewish Merchants in Medieval Europe. The Jews played a prominent role as middlemen/merchants in long-distance Mediterranean trade during the commercial revolution of the Middle Ages, 950–1350.

> The tenth century and early eleventh marked the high point of Jewish prominence in long-distance trade, not only in Christian countries, but also in the larger part of the Muslim world. The absolute volume of their transactions was of course restricted by limited opportunities of that age, but their share of the total was so considerable that Frankish and Byzantine regulation of foreign trade often referred to "the Jews and other merchants" (Lopez 1971, p. 61).

In the long-distance trading network, Jews played an indispensable role in the medieval city-state of Venice, a city of merchants in which the ruling aristocracy was itself a commercial class. The Jews were the principal intermediaries between the Italian merchants and other foreign merchants who came to Venice to trade during the heyday of the Venetian empire. They "controlled much of the city's trade, in spices, woolens, sugar and silks, and they were irreplaceable on Rialto, the central money market" (Morris, 1980, p. 145).

Why were Jews so prominent as middlemen in the Middle Ages? According to Lopez (1971, p. 61) the "peculiar economic position of the Jews was to some extent a by-product of their religious identity and social structure." The Jewish merchants were involved in

> a wide and tight network of interconnected communities, whose members were keenly aware of what was going on in far-away countries and whose business methods were far in advance of those of their non-Jewish contemporaries (Lopez, 1971, p. 61).

According to Zenner (1983) the medieval development of the Jews as a trading diaspora—a network of dispersed trading settlements—made possible the organization of trust and credit over long distances:

> [L]ong-distance trade centered around family firms and often ethnically and culturally homogeneous groups. Common ancestry, languages, and religion provided the basis for a moral community which could enforce ostracism (for example, boycotts, excommunication) when no common territory existed. . . .
>
> The fact that such a moral community over long distances supports trade also reinforces the diaspora as a whole, since the survival of the group depends on having communications, distinctiveness, and a way of enforcing its norms over great distances. Being involved in an occupation with other members of one's group means that your livelihood depends on your fellow kinsmen and co-ethnics (co-religionists) and makes leaving the group more difficult (151–152).

In this organization of trust and credit over long distance, Jewish religion played an important role: Jewish religious life prescribes a dual standard of ethics, i.e., fellow Jews are obliged to help each other but a Jew is not obliged to help an outsider. This dual standard of ethics fosters internal solidarity among Jewish merchants.

Jews in Jerba, Tunisia. A closer look at a particular Jewish community in present-day Jerba, Tunisia, (Udovitch and Valensi, 1984) provides further insights into the group-specific capacity of Jewish merchants to govern themselves. By the first half of the eleventh century, Jews in Jerba emerged as a well-established community. They participated in the commercial revolution of the Mediterranean world: they were engaged in trade that extended from Spain through Tunisia and Sicily to Egypt and beyond to South Arabia and India. As part of the international network, they traded not only with co-religionists from Tunisia and Egypt, but also with Italians from Amalfi, Genoa, and Venice who came to North Africa to trade.

Within present-day Jerba, the Jews—numbering about 1,200—dominated two occupations: textiles and the jewelry trade. It is precisely in the jewelry trade, where mutual trust is crucial between exchange partners, that

> the clientalization of exchange does not cross ethnic boundaries but takes place between the Jewish producers in the Jara and their coreligionists merchant-distributors in the suq (Udovitch and Valensi, 1984, p. 117).

The social distance between the jewelers is not very great. Furthermore,

> professional relationships between the jewelers are multiple—between specialists and generalists, between producers and sellers—with each category constantly dependent, complex and constantly shifting. This professional interaction supplements earlier ties of kinship, studentship, and the like. And just as the relationships between jewelers are multiple and multi-layered, so too does the individual jeweler fulfill several functions in different spheres simultaneously. A Jewish jeweler is not simply a jeweler; he may also be the head of a synagogue, a part-time scribe, the community circumciser, or a member of the burial society. In Jerba, possessing the skills to produce or sell jewelry is not enough to make one a jeweler. One has, first and foremost, to find a place within a closely knit social—even more than economic—network. Since similar rules govern other occupations, it is once again, according to ethnic, religious and communal affiliations that the division of labor operates and perpetuates itself (Udovitch and Valensi, 1984, p. 111).

Within the close-knit social and economic network, the mutual trust between the jewelers are based on Jewish cultural and legal traditions. The Jews are "people of the law" and adhere strictly to the law. They emphasize reliability and faith (Hebrew: *imun*) and integrity (Hebrew: *yashar*). These values are reflected in their economic dealings with each other. The same values of trust and integrity in business dealings among the jewelers, when extended across Jewish boundaries to economic transactions with Muslims in the heterogeneous *suq* (market), become crystallized in the notion of *haqq al-yahud* (Udovitch and Valensi, 1984, p. 29):

> *Haqq al-yahud*, the law and lawfulness of the Jews, is the basis for the trust they [Jerban Jews] enjoy in the economic sphere, especially in the jeweler's trade.

Haqq al-yahud, a concept which governs the exchange relations between Jews and Muslims,

> implies a long list of qualities: skill and reliability in performing work, honesty in transactions and in keeping accounts. This notion summarizes the good relations between buyers and sellers. Needless to say, this ideal of mercantile ethics does not necessarily reflect the reality of the Jerban market. It is primarily the Jews who attribute to the *haqq al-yahud* their success in the market place. But even Muslims accept this image, because it marks the limits which Jewish merchants cannot violate in their commercial practice (Udovitch and Valensi, 1984, p. 117).

It is worth noting that just as the Chinese middlemen in Southeast Asia emphasize the importance of *hsing yoong/sun yung* in transactions as a key factor contributing to their entrepreneurial success, so the Jerban Jews attribute the role of *haqq al-yahud* as playing an important role in their success vis-à-vis the Muslim population.

Jews in Present-day Antwerp, Amsterdam, and New York. The number of Jews living in Antwerp, Belgium, in 1966 was estimated to be 10,500 out of a total population of 550,000. Antwerp, a major center of commerce and industry, is one of the largest ports in the world. About 80 percent of the Jewish population are engaged in the diamond trade and industry, an economic activity which they dominate (Gurwirth, 1968). The occupation of cleaving, a craft which helps transform a rough diamond into a brilliant one, is a Jewish monopoly. Jews also monopolized the import-export trade in diamonds: as traders and dealers, they import rough diamonds (both industrial diamonds and stones intended for gems) from producing countries, and export finished products to buyers, with the United States as the principal buyer.

A substantial portion of all diamond transactions occur in the buildings of four diamond exchanges. In the three principal exchanges, Jews represented 70–83 percent of the total membership of 1,500, 1,600, and 1,700 respectively. The two most active exchanges are (1) the *Beurs voor Diamanthandel* (Diamond Exchange) the most important international center for the export trade in cut diamonds, and (2) the *Diamantkring* (or simply the *Kring*) which concentrates on the importation of rough diamonds.

Diamond transactions require a great deal of trust on the part of dealers because of the need to constantly bargain and negotiate about the quality of diamonds exchanged between buyers and sellers, and because of the opportunities for theft and fraud. This explains why the diamond trade

> takes place within a comparatively close and limited group: the participants (often linked by friendship) are formed into a loose type of association with its own codes and sets of rules to which they adhere . . . Yiddish, a true lingua franca of the diamond community emphasizes the confidential nature of the economic arrangements (Gutwirth, 1968, p. 133).

The group involved in the diamond trade and industry is a homogeneous religious group whose members speak the same language, Yiddish, a "truly remarkable phenomenon, since in contrast to the other three languages [Hebrew, French, and Flemish] there is very little formal teaching of Yiddish" (Gutwirth, 1968, p. 124). Within the group, there is a further specialization and division of labor along religious lines: the export trade is dominated by the less orthodox Jews, while the ultraorthodox Hassidic Jews—identified by their long beards, sidelocks, gabardines and fur hats—dominate the import/local diamond markets/the *Kring*.

Economic life and social life of the Jewish community are closely intertwined. The Hassidic Jews play an important role in preserving Jewish identity via dietary laws and other religious rituals. Prominent members of the diamond trade and industry are often also the leaders of the various associations—lay, semi-associations, cultural clubs—whose functions include assisting immigrants from Central Europe into Antwerp, promoting *tsedake* (charity and solidarity as it was practiced in Central and Eastern Europe), as well as various cultural activities.

Within the close-knit Jewish community in Antwerp, disputes are settled in rabbinical courts in which rabbis, through conciliation and arbitration, render judgments of suits voluntarily submitted by the members of the Jewish community. Disputes among diamond dealers are submitted to their own exchanges:

> . . . diamond dealers are not subject to rabbinical courts, they have, in their Exchanges, a special procedure for resolving their conflicts. These are largely settled by conciliation or arbitration—as is the case in rabbinical courts. Admittedly, the final judgments of the arbiters could be flouted by an appeal to the national courts, but it is practically unknown for Exchange members to have recourse to civil law. As is the case with litigants appearing before a rabbinical tribunal, the Exchange members prefer to make use of national courts of justice only in cases which call for the exercise of coercion (police, prison, etc.), and even then they do so generally after obtaining the consent of the Exchange executive. Again, as with other disputes brought before a rabbinical tribunal, many of the conflicts which arise in the industry could not, in any case, be brought before the national courts; moreover, those that could be brought before these courts might be dealt with according to a procedure and a code (and subject to sanctions) which are quite different from those obtaining in the Exchanges. The latter's methods of coercion—moral, social, and economic—are (as in the case of sanctions imposed by a rabbinical court) dependent upon voluntary submission of the members. Even if they are expelled or suspended from the Exchange, the members can, in several cases, continue to engage in their trade or occupation (Gutwirth, 1968, pp. 133–134).

The same attributes of honesty and reliability in transactions and the group-specific capacity to govern themselves explains why the the diamond trade in Amsterdam and in New York is dominated by a close-knit group of Jews who conduct transactions among themselves on the basis of handshake.

From the above descriptions of the various EHMGs in Southeast Asia, in Africa and in Medieval Europe, it is possible to identify the following general features of the EHMGs operating in less developed countries (LDCs):

1. A multiplicity of middlemen operate at different levels of the marketing structure so as to form trading networks;

2. Middlemen belong to tightly knit groups so that their exchange is characterized by personalistic or particularistic interaction based on kinship, ethnic or religious ties;

3. Codes of ethics of mutual aid and reciprocity, embedded in these networks, function as de facto contract law for the enforcement of contracts;

4. Violation of informal norms of behavior of the group results in individual and group sanctions imposed on the offending party.

We may thus consider the EHMG as an informal institutional arrangement for the protection of contracts. How can economic theory explain the phenomenon?

A Theory of the EHMG: The New Institutional Economics

The search for a theoretical framework to understand ethnically homogeneous middleman groups (EHMGs) leads to Transaction Cost Economics, which is part of the New Institutional Economics.[5] Central to the New Institutional Economics is the notion that laws and institutions can have a significant impact on trade through their effect on transaction costs. Coase's (1937) explanation of the nature of the firm laid the foundations of Transaction Cost Economics. The costs of any transaction include costs of search for trading partners and costs of contract negotiation and enforcement. The institution of the firm, according to Coase, emerges to economize on costs of contract negotiation.

Controlling Opportunism. Costs of enforcement arise from what Williamson (1975, 1985) calls "opportunism" or "self-seeking with guile." Breach of contract is an example of opportunism. Contract law and the vertically integrated firm are institutional arrangements to economize on costs arising from opportunistic behavior. Landa (1976, 1987) has developed a theory of contract law which protects traders' "profit expectations" and, thereby, promotes middleman entrepreneurship. Contract law reduces the incentive for a potential trading partner to breach his contract by assigning liability for damages if he violates terms of the exchange.

Williamson (1975, 1985) has shown that vertical integration is a solution to the problem of opportunism. It is one of the alternative modes of economic organization or "governance structures"—markets, hierarchies, and relational contracting—for coping with opportunistic behavior in developed capitalist economies.

Arrow (1970) has identified yet another way opportunistic behavior is being constrained: the existence of codes of behavior/ethics which establish mutual trust between two parties who share the same code. The existence of trust reduces transaction costs. Without trust, transaction costs may be so high as to lead to market failure. Arrow thus links the concept of transaction costs with the concept of market failure. But despite Arrow's emphasis on the importance of trust in facilitating trade, few economists have paid attention to the role of formal and informal norms in the process of exchange. And, with the exception of scholars from the Austrian and Public Choice schools, most economists devote little attention to the emergence of social institutions. Social institutions, defined as rules, "refer to prescriptions commonly known and used by a set of participants to order repetitive, interdependent relationships. Prescriptions refer to actions (or states of the world) which are *required*, *prohibited*, or *permitted*" (E. Ostrom, 1986, p. 5).

The Austrian approach associated with writers such as Menger and Hayek views emergence of social institutions as the result of market processes and other forms of spontaneous individual action. In other words, institutions emerge in an unintended manner without any design directed toward their creation.[6]

Public Choice theory,[7] the economic analysis of politics associated with the work of James Buchanan and Gordon Tullock (1962), explains the conceptual origins of institutions in terms of a contractarian paradigm (Buchanan, May 1975). Using a Prisoner's Dilemma paradigm, Buchanan showed that both parties in an exchange, finding themselves in the Pareto-inferior position when both were made worse off by not cooperating, will enter into a "social contract" to choose the rules of the game to be enforced by the state. Institutions, then, can be seen as emerging from the public choice of individuals acting as rational human beings who participate in both the economic and the political arenas.

When attention is shifted to the LDCs, the EHMG reveals itself to be a form of economic organization that is neither a market-oriented, vertically integrated firm nor a state/contract law mechanism for coordinating activities of middlemen across markets. And because attention is focused on the ethnic character of the middleman group, a theory of the EHMG must go beyond the New Institutional Economics to establish links with sociology and anthropology. What follows is a theory of the EHMG that integrates several key concepts from various social sciences—economics, law, game theory, sociology, and anthropology—into a broader transaction-cost framework.

Role of EHMG in Constraining Opportunism. In multiethnic societies, the most visible and reliable indicator of group membership is ethnic identity: appearance, language, and ritual (Landa, 1981; Carr and Landa, 1983). For the establishment of productive and enduring trading relationships, ethnicity is an important consideration because the respective groups represent moral communities whose shared norms and values are reflected in their business practices.

Under conditions of contract uncertainty, a rational trader will not indiscriminately enter into exchange relations with anonymous traders. This is because at any particular point in time, an individual is embedded in social structures—the family, clan, and ethnic/tribal group—whose rules serve to constrain his behavior. "Social structure" is a key concept sociologists use to describe the pattern of recurrent and regularized interaction among two or more persons, hence implying the existence of norms or institutions for regulating behavior (Blau, 1975).

A rational economic man under conditions of contract uncertainty will enter into particularistic or personalistic exchanges with traders known to be trustworthy in honoring contracts. In order to choose a network of reliable trading partners, the trader will equip himself with a "calculus of relations" (Fortes, 1969) which enables him to rank all traders in a market according to their suitability for reciprocal relations.

Among the criteria used in evaluating potential trading partners is the degree of social distance or social relatedness between those seeking mutual exchange. The closer the social distance, the greater is the degree of shared attitudes and values. The more established the existing bonds of reciprocity, the greater is the degree of trust that a potential trading partner will honor contractual obligations.

Sahlins (1969) has developed a model of reciprocity based on social distance. Ego is at the center of a series of ever-expanding concentric circles. Each circle represents a degree of relatedness or social distance. The smallest circle represents the small number of close kin. As Ego moves outwards, the circles become larger; so does the number of persons involved. Trust and reciprocity is greatest among close kin and decreases as social distance increases, until at the boundary of one's ethnic group, mistrust and/or "negative reciprocity" emerges.

When Ego chooses a least-cost network of trading partners, he will favor kin over nonkin, close kin over distant kin, fellow ethnics over outsiders, as he moves from the center outwards towards the ethnic boundary. The ethnic group thus represents the outer limits of that group of near or distant kinsmen whom one can trust. The significance of the concept of ethnic boundary to describe discrete groups of people, as anthropologist Barth (1969) points out, is that

> ethnic boundary canalizes social life . . . it entails a frequently quite complex organization of behavior and social relations. The identification of another person as a fellow member of an ethnic group implies a sharing of criteria for evaluation and judgment. It thus entails the assumption that the two are fundamentally *playing the same game* [italics supplied] . . . On the other hand, a dichotomization of others as strangers, as members of another ethnic group, implies a recognition of limitations on shared understanding, differences in the criteria for judgment of value and performance,

> and a restriction of interaction to sections of assumed common understanding and mutual interest (p. 15).

For some traders, the Ego-centered trading network will become truncated at the ethnic/religious boundary: the trader will not transact across the boundary when the costs of contract enforcement with outsiders are perceived to be greater than the benefits of trading with outsiders. The costs of contract enforcement are especially high when outsiders are perceived by Ego to play by different rules of the game, which, in a trading context, include the duty to honor one's contractual obligations.

For other traders who must cross the ethnic/religious boundary in order to have access to the source of supply, the relevant comparison is the costs of enforcing contracts with outsiders, including the costs of using an institutional mechanism like cash transactions to cope with the problem of breach of contract, with the opportunity costs of excluding outsiders. The outcome of Ego's subjective calculus of relations in determining the objective mix of trading partners in the network therefore depends upon: (1) the number of members in the constituent concentric circles, (2) the degree of heterogeneity of the population, and (3) the balance at the margin between transaction costs of protecting contracts and the opportunity costs of exclusion of outsiders. Given an interdependent, nondecomposable middleman economy, the structural effects of many individual middlemen's discriminatory rational choices of trustworthy traders is the emergence of an EHMG within the larger heterogeneous trading network.

Significance of EHMGs. The economic significance of the EHMG is that members of the same ethnic group form a moral community sharing the same rules of the game so that norms of behavior embedded in middlemen exchange networks function to constrain traders from breach. Violation of the rules results in individual and group sanctions being imposed on the offending party. Thus, cultural norms of behavior embedded in the EHMG can be considered as "focal points" (Schelling, 1960)—a game-theoretic concept—which facilitate the coordination of the activities of interdependent middlemen across markets. At the same time, cultural norms of behavior function as a screening device to exclude outsiders who do not belong to the same moral community of merchants.

Norms of behavior in the EHMG emerge from an invisible-hand process. But since the EHMG is a part of a larger ethnic/religious group with well-defined standards of behavior, an explanation of how norms may have emerged historically via a Public Choice process (our theory of the EHMG which combines an Austrian approach with the Public Choice approach) may be called a "reflexive theory of the emergence of norms."[8] In this theory, social norms embedded in the EHMG are seen as *emergent* phenomena in highly complex, multitiered systems. Traders, operating at the individual microlevel, are aware that they are not disembedded individuals but belong to larger macro-units, i.e., well-defined ethnic groups whose members share a specific ethnic identity and ethnic-specific group norms (Confucian code, Hindu caste code, Muslim law, Hebrew law).

This capacity for self-conscious reflection on the part of individual traders enables each of them to deliberately develop particularistic trading networks to cope with the problem of contract uncertainty. But the structural effects of the rational choices of many traders in creating the macrophenomena of EHMGs may *not* be fully understood by the traders. Thus, there are elements of spontaneity (as in the Austrian theory of the evolution of institutions) as well as design (as in the Public Choice approach).[9]

Under conditions of contract uncertainty, kinship/ethnic status is a valuable intangible asset for a potential trading partner because of the "priority rights" Ego confers upon those who share membership in his ethnic community. But kinship or ethnic status is not a "right" that can be purchased by those who lack the requisite status. Status is acquired by virtue of a person being born into a particular kinship/ethnic group; thus kinship/ethnic status may be regarded as a species of "status rights" (Dales, 1972), the set of rights lying between private property and common property rights. Only those "insiders" who have the requisite status rights can become middlemen. The "outsiders," being de facto without status rights, are excluded from middleman roles because they cannot obtain an essential nonmarketable asset necessary for middleman-entrepreneurship.

If industry conditions are favorable for expansion of middleman activities, the value of status rights as an entry ticket into personalistic markets rises. Thus, under conditions of contract uncertainty, insiders have a differential advantage vis-à-vis outsiders in appropriating new middleman roles for themselves.

Outsiders may try to compensate for the lack of status through investment in reputation or trying to "pass," both of which are not costless. The transaction costs of an outsider are higher than those of a trader who is an insider. These high transaction costs of outsiders, constitute an entry barrier into personalistic middleman markets. Thus, the persistent boundary of the EHMG is explained by two factors: (1) insiders discriminating against outsiders in order to economize on transaction costs of contract enforcement, and (2) the differential costs of outsiders in gaining access to personalistic middleman networks.

From the point of view of the EHMG, the informal social norms embedded in the group (whether they be Confucian ethics for Chinese middlemen in Southeast Asia, the Hindu caste code for Indians in Africa, Muslim law for Lebanese traders in West Africa, or Hebrew law for Jews in Europe and elsewhere) may be regarded as local public good/public capital for the whole community. To the extent that this type of local public capital is *specific* to particular ethnic groups, the social norms of the group may be regarded as *ethnic-specific assets* essential for successful middleman-entrepreneurship operating under conditions of contract uncertainty.[10]

Implications of Theory for Policy

A number of policy implications flow from the theory of the ethnically homogeneous middleman group (EHMG):

Fundamental Role of Laws and Institutions. In order to promote economic development of LDCs, basic infrastructure must be provided. Far too often, development economists, politicians, and donors interested in giving aid to LDCs, concentrate on the visible infrastructure—roads, bridges, credit markets, and financial intermediaries—to the neglect of the invisible institutional infrastructure. This is a mistake. The fundamental institutional problem is that of law and order. An economy must have a structure of rules—Adam Smith's "laws and institutions"—for protecting property rights and enforcing contracts. Without such a structure of rules, transaction costs may be so high as to impede the development of markets. Well-functioning markets therefore must be supported by a system of laws and institutions. Thus the laws and institutions that regulate conduct of market activities are fundamental parts of a society's infrastructure.[11]

Where the legal framework is not well developed, as in LDCs, only those who create for themselves informal law as a substitute for formal law can successfully become entrepreneurs. It is therefore not surprising to find that successful middleman entrepreneurship, which calls for a great deal of mutual trust and cooperation, is monopolized by ethnic groups whose culture and social structure emphasize mutual aid and cooperation, including keeping promises among those with well-defined relations vis-à-vis each other. The fact that EHMGs can function effectively in the "shadow of the law" indirectly points to the important role of formal law in promoting entrepreneurship and economic development. It is in this context that de Soto's empirical work is so significant in emphasizing the crucial contribution of facilitative law to the economic development of LDCs.

Inadequate Measure of the Informal Sector. The existence of EHMGs allows middleman economies to function as credit economies; the trust among members of the group make it possible to extend credit to each other. Therefore, measuring the size of the informal/underground sector by using the cash criterion (e.g., Litan et al., 1986) underestimates the size and hence the importance of such sector.

EHMGs as Discriminatory or Exclusive Clubs. Under conditions of contract uncertainty, a member of an EHMG incurs either the opportunity costs of excluding outsiders from trade or the costs of using cash transactions when crossing ethnic boundaries. The outsider, without the requisite status, must incur the costs of acquiring reputation/"passing"; such costs may act as effective entry barriers. Consequently, the trading group may be smaller than the optimum network, which would include both insiders and outsiders (Cooter and Landa, 1984). A trading network that is monopolized by a nonindigenous population, may engender hostility of the indigenous population towards nonindigenous middlemen. The societal costs of this antagonism are the potential for racial conflict and violence in plural societies. In de Soto's underground economy, entrepreneurs who are forced to cooperate on a tribal basis, will of necessity exclude nontribal members.

Contract Law Versus Collective Action. Destroying these nonindigenous trading networks by expulsion of middlemen—e.g., the experience in Indonesia in the 1960s and in Uganda in the 1970s—is not a viable solution because these middlemen facilitate trade and economic development. One alternative to the formation of discriminatory or exclusive clubs is to develop/improve contract law (Cooter and Landa, 1984). Improvements in contract law enlarge the size of the trading group which now becomes more heterogeneous because insiders have the opportunity to cross ethnic boundaries to trade with outsiders. Another alternative is to encourage indigenous populations to develop group-specific capacity for self-governance, including the capability to create social norms for the enforcement of contracts.

Robert H. Bates

Comment

These comments will be not only on the paper by Janet Landa but also on the paper by Hernando de Soto. They will be directed toward clarifying what the "informal sector" is, what it can and cannot do, and why it is not in fact fulfilling its promise for development.

The recent popularity of the informal sector in the development community derives from its resemblance to the private market. It provides an arena for entrepreneurship and risk taking. Its members venture capital in private enterprises and innovate new ways of performing old functions at lesser cost. In addition, its members compete; rather than the few licensed firms in a given sector of the formal economy, there appear to be a multitude of competing firms in the informal economy, and few barriers to prevent new ones from entering.

Firms in the informal sector appear to be efficient in the static sense. They conserve resources which are scarce, such as capital; and they make intensive use of factors which are relatively abundant, such as labor. They also appear to be efficient in the dynamic sense. As the paper by Biggs, Grindle, and Snodgrass shows, they apparently adapt quickly to external shocks.

Lastly, the informal sector is attractive to development specialists because its members behave in ways which promote social objectives. Because its firms make intensive use of labor, they promote labor absorption and employment; and by generating incomes among those excluded from the benefits provided by official programs, they promote a more desirable distribution of income as well.

One attribute of the informal sector, then, is that it appears to resemble the private market and to exhibit many of the virtues which advocates of the market would like to claim for it. But it is also clear that the informal sector is not the same as the private market. For in Third World nations, it exists alongside and in reaction to an official economy whose scope and weight vastly exceed, in relative terms, the official economy which exists in market-oriented economic systems. What is profitable and worth doing in the informal sector is determined largely by the behavior of the official sector. People in the informal sector maximize subject to the decisions and choices made by those in the formal sector. The informal sector is thus a reactive sector.

The informal sector thus bears many of the attributes of the private market. But it is a private market in which economic agents maximize in reaction to official markets. Both attributes of the informal sector strongly affect what it can, and cannot, do. They have strong implications for the behavior of the informal economy and for its potential growth and development.

Clearly, the more the informal sector resembles the private market, the less it is likely to provide some kinds of the goods and services which people value. People value roads, schools, and other public goods; they do so in the developing areas at least as much as they do in the developed world. And, as the basic arguments of welfare economics demonstrate, we cannot expect those who exhibit the attitudes and who adopt the strategies which make them successful in private markets to make the kinds of choices which result in the production of public goods. Insofar as those in the developing societies need or value the provision of public goods, they will therefore find the informal sector disappointing.

Landa's paper, ironically, brings into focus important limitations of the informal sector. She documents the capacity of merchants and traders to provide conventions which resemble public goods: property rights, which facilitate the making of contracts and which underpin markets for credit. It is important to recognize, however, the limitations inherent in the institutions which she describes. It is fairly clear that the systems Landa documents represent forms of private rather than public law. The sanctions and protections of these legal systems extend, Landa demonstrates, only to particular ethnic or religious groups, and are not accessible to all members of the polity. Moreover, a close reading of Landa's analysis would suggest that they extend only to commerce and trading and not to large-scale investments.

Informal legal systems appear to require for their maintenance repeated contact and repeated transactions. They depend on the formation and preservation of reputations, either of product quality or of personal probity. And the incentives to form such reputations would appear to rest on the capacity of others to impose sanctions over a long stream of future transactions. Such conditions of "repeated play" are far more likely to be met in commerce than they are in the sphere of, say, industrial investment; in the latter, single shot, one of a kind transactions are far more common. They are also highly significant, as the creation and formation of specialized plant and equipment is often necessary to the creation of a modern, industrial sector.

The legal systems analyzed by Landa may provide the public goods which support an active and efficient "informal" commercial sector; but they are far less likely to provide the legal infrastructure which will safeguard large-scale, productive investment and thereby generate rapid industrial growth.

Because the informal sector represents a form of private economy, it is not only likely to provide too few of some kinds of goods, it is also likely to provide too many of the kinds of goods which people dislike. I refer to "externalities," such as foul air, dirty streets, noise, and so forth. As suggested by de Soto, the informal sector often possesses a bad reputation; its members are viewed as being selfish, uncaring of the consequences of their actions on others, and lacking a regard for the public impact of their private behaviors. Where externalities can be imposed, we should expect the private market to create too many of them. And insofar as the informal sector resembles the private market, it can be expected to impose externalities, generating welfare losses even while exhibiting the virtues of entrepreneurship, competition, and so forth.

The behavior and performance of the informal sector is also conditioned by the fact that it is a reactive economy; it is an economy whose existence and behavior is defined in relation to an official economy. One implication is that while the informal economy may exhibit many of the desirable properties of the private market, the resources which are allocated in it may in fact be allocated in their second best use. Many resources may enter the informal economy simply because they face government regulations, taxes, or government controls which make it unprofitable to employ them in their most productive use.

Many of the activities in the informal sector are illegal. One implication is that many of the activities which take place in it are very expensive; they require high levels of insurance. One form of insurance is remaining inconspicuous; activities therefore take place at a lower scale than may be efficient, or in sites or locations that are less than optimal. Another is the purchasing of protection, as by paying bribes to political patrons or government inspectors. Another implication is that many forms of economic activity which should exist do not; the entrepreneurial spirit which is exhibited in the informal economy does not extend to the building of large plants or big projects, whose visibility would endanger the investment. Once again, it becomes apparent that the informal sector provides a more hospitable environment to commerce and trading, where goods are movable and turn over quickly, than to large-scale, fixed investments.

These counterbalancing arguments notwithstanding, it is clear that there are many desirable features to the informal sector. While embodying many of the limitations of the private market, it also embodies many of its virtues. The questions then arise: Why is there so little public action in support of its growth and expansion? Why is there so little organized support for the privatization of economic activity and the retrenchment of government in the Third World? Why does so desirable an institution possess so little political support?

In approaching these questions, it is useful to address them first from the point of view of those in the private market and then to shift to the vantage point of those in government. We can then begin to understand why the potential demand for market liberalization has failed to become an effective demand and to receive organized political expression.

The informal economy is a reactive economy. The implication is that much of the profitability of activities in the informal economy result precisely from the existing structure of official policies. Were quotas to be relaxed or tariffs lowered, activities which had been sheltered would then be subject to external competition. Were licenses more readily available, price controls relaxed, and credit markets liberalized, then domestic competition would increase as well. The activities which prosper in the informal economy because they circumvent restrictions on competition imposed by government policies would therefore lose many of their special advantages. Those who earn profits in the shadow of legality may wonder if they could survive in an openly competitive environment.

In addition, it is likely that many of the most profitable activities in this reactive economy would cease being profitable were markets liberalized. In economies characterized by government interventions, there are shortages which are created by governmental restrictions. Many of the profits in the informal economy are earned by circumventing these shortages and by allocating resources whose supply has been rendered scarce as a consequence of government policies. These profits would be threatened by liberalizing reforms.

In addition, those in the shadow economy who benefit from the special relationships they possess with authorities in the official economy would lose out as a consequence of the ending of government controls. For they possess special advantages from their connections; they may gain credit as a result of official favor, foreign exchange as a result of political influence, or inputs purchased for use in state industries but diverted to the private market in exchange for bribes.

Some of the biggest and most prosperous "entrepreneurs" in the informal economy may favor, therefore, the retention of the current way of doing business. Rather than acting as active proponents of privatization, these leaders of the informal economy may seek to sabotage efforts to promote a greater role for private markets.

That the informal market exists in reaction to official policy means that activities which are profitable conditional on the present set of government policies may become unprofitable subsequent to liberalizing reforms. The "leaders" of the informal economy may therefore not be champions of private markets, nor provide organizational leadership for the cause of market liberalization.

Even were it likely that all economic activities in the formal sector would become more profitable as a result of reforms, we nonetheless might not expect to find an organized demand for the promotion of private markets originating within the informal economy. For given that the patterns of economic activity within it have been chosen by agents maximizing in reaction to government policies, a shift in government policy produces risk; in order to maximize profits, persons will have to adjust their behavior following the change in policy. Incomes within the highly regulated economic environment may be lower than they would be in an unregulated environment; but the post-reform incomes represent future and therefore uncertain prospects. And risk-averse agents, behaving rationally, may therefore prefer regulated incomes to the "lottery" offered by unregulated markets and policy reform.

The lottery (risk) offered by policy change would gain in relative value the worse the earnings prospects in the informal economy. An implication is that economic reform becomes more likely the more adverse the economic conditions under regulated markets. Another is that it takes a good deal of economic decline to produce a demand for market deregulation.

Rational individuals might not prefer the movement to freer markets. Even were freer markets also to produce on average better incomes for all, it is rational for private agents not to organize in support of policy reform. That is, even were all members of the informal economy to prefer free markets, they might well, behaving rationally, fail to organize in support of them.

As we have seen, it is likely that the larger agents in the informal market benefit from its coexistence with the official market; the remaining members of the market are likely to be smaller in size and more numerous. The result is that even if they were to prefer policy reform, behaving as individual maximizers, they might well fail to combine in support of it. For the movement toward an efficient economic regime represents a collective good; it is a movement from which all can expect to benefit. Rational individuals may therefore choose to free ride—to let someone else bear the costs and risks of opposing the present economic regime while awaiting the prospects of gaining the resultant rewards for free. And the atomistic nature of the structure of the informal economy strengthens the incentives to forego individual actions in support of collective interests.

Attributes of the informal market therefore render it an infertile source of demands for economic liberalization. Is it possible that the impetus to organize may originate from the political class? Given that collective benefits may be generated by policy reform, might not politicians seeking an issue with which to gain political support articulate the interests of the informal sector?

At first glance, one might expect affirmative answers to these questions; and purely on theoretical grounds, such answers would appear justified. Political entrepreneurship is often cited as a source of overcoming the incentives which mitigate against the provision of public goods. The problem with applying this analysis to this case is that it leaves out of consideration the context within which private markets have to be formed. In the status quo, markets have been transformed into political organizations, with the consequence that competing politicians will find it difficult to advocate the withdrawal of the government from markets, even in circumstances where the majority of their constituents would find it in their collective interests for government to do so.

When governments intervene in markets, they shift prices away from their market-clearing levels. To illustrate our argument, we can assume that they have acted so as to lower market prices. At official prices, demand will increase and supply decrease, with the result that there will be excess demand. As a consequence, the good must be rationed. And the political officials in charge of the market then get to allocate the good to their political supporters and to withhold it from their political enemies. They gain the capacity to target their favors. They thus transform the market into a political organization.

In a competitive political environment, everyone may realize that there are economic benefits to be had from the withdrawal of governments from markets. But no single politician could afford unilaterally to abjure the prevailing pattern of market intervention. To do so unilaterally would be to undercut the basis of one's political organization; it would leave the advantage with any political opponent who might promise to continue the policies which nurture the economic fortunes of political cronies and economic hangers on. The advantage thus lies with the old guard, i.e., whoever persists in protectionist ways while others advocated market reformism. Unless all politicians simultaneously switch to a reformist platform, then, no single politician will be able to do so.

The implication is that even though people may prefer to shift to private markets, reformist movements are unlikely to organize. Economic elites in the informal sector are unlikely to champion them. The non-elites may not prefer the gamble of reformism to the certainty equivalent of their present earnings. Conditions in the informal sector militate against the creation of spontaneous collective movements in support of reformism. And the political elite will find the tactical advantage lying with the old guard.

The informal sector may present many attractions. But clearly it is an institution which better promotes commerce than industry, and trade rather than investment. Its blessings are mixed, moreover; for like any private market it does not support public-spirited behavior. And even the strength of its virtues will not be sufficient to precipitate collective movements in its favor. The promotion of private markets requires political action. And the defining characteristics of the informal sector—its dependent relationship to the official sector and its market-like atomistic structure—mean that individual agents, behaving rationally, may choose politically not to promote its fortunes.

Political movements devoted to minimalist governments are rare in the developing world. And these remarks suggest why that is so.

Discussion

MR. GRAYZEL: This is such an important area that I would like to introduce what I think is a very important clarification; one I think we must make if we are to avoid making a lot of mistakes and trapping ourselves in our own concepts.

There is a very important difference between law with a big "L" and law with a little "l," between legal and adjudication processes, on the one hand, and the specific rules and regulations, on the other hand. Both of these types of laws exist on every level of every society, from the family up to the top political unit.

A critical factor causing much confusion is our propensity to mix up realities occurring on different levels. We often speak about the legal process that's occurring at one level while citing the rules that are operative on another level. When we cross cultural boundaries and national boundaries we often confuse entire systems.

For example, under the common law system there is such an interrelation between the written law and the forums of adjudication, the courts, that we use the one word "law" for both. It's dramatically different in other systems. For example, I know someone who worked in a Brazilian bank and could not understand why the written rules for loans were not being systematically enforced. Finally somebody explained to her that the real "unwritten" rule was "for your friends everything, for your enemies nothing, for everyone else the law."

In such systems, what we see as the law, namely, the official rules and regulations, really operate as barriers to the fair application of the unwritten rules that really determine who gets what. Nobody obeys the law that we identify as the law in these situations because it's virtually unmanageable. Conversely, it is this "unmanageability" that allows official rules to function as effective if unfair barriers that divide areas of operation in which different groups are allowed to work under their own unofficial but manageable legal processes. The informals, the people out on the street, have their own legal system and their rules, and the elite have their own legal systems and rules. And the law that we think is the law is really a de facto gate keeper between these different social strata and processes.

The reason this understanding is so crucial and important in development is because we so often don't understand what we are really doing when we affect these legal systems. If you move into one of these bifurcated systems and you think you're improving it by reinforcing the formal laws that act as de facto legal barriers, what you actually do is work against the least powerful elements of the population: the poor informals.

For instance, in many African contexts, there is a traditional legal system in rural areas for rural land while in the cities there is a modern legal system for urban holdings. Modernizing agents come in and think they are going to secure the informal rights of the traditional people by legalizing rural land tenure. In fact what happens is that the traditional legal system is discredited and destroyed but no new manageable forums are created that are really accessible to traditional non-elite rural people. As a result modern urban elites then get an opportunity to grab the rural land because they are the ones who benefit by the reinforcement of the formal, modern and hard-to-access legal process that they know how to manipulate or avoid.

However, even though in many cases regulation works against the informal sector, new alternatives to the status quo must be considered. If you don't do something to incorporate what we've been calling the informal sector into the formal sector, you're going to progressively deny informal sector participants more and more access to all sorts of important resources that come through modern legal structures, such as large loans, larger markets, greater contractual protection and big business opportunities in general.

I can cite two possibilities. One is to directly incorporate traditional, informal legal structures into new modern legal structures. You can do this, for instance, by recognizing traditional land law as common law and accept it as of equal weight to new deeds of title. You can also accept traditional forum decisions as binding. Even in our own system, we have a whole new growing body of law called "alternative dispute resolution" which is beginning to be incorporated into our court system and to enforce agreements reached under voluntary arbitration. Another striking example is how with recent changes in U.S. Immigration law we've recognized as new citizens in this country people who originally established their residence illegally. Basically, we decided we were going to recognize them and incorporate them formally rather than keep them informal.

Another alternative is to create new forums and processes which force the informal and formal to work together. And in a way much emphasis on improving the market system seeks to do this. When we talk about an open market we're talking in theory about a more open forum for bringing those two groups together.

In any case, I think in our discussions we have to keep those distinctions clear and make sure we understand which level we're working on and the difference between legal processes, the written law, and the real unwritten rules. If not, we risk continuing to often have a negative influence. We risk reinforcing the formalistic law in a way that just further empowers a small, elite group to manipulate their one side of the equation even more than they have in the past.

MR. de SOTO: I think these remarks are extremely important. I would even like to encourage a colleague of mine, Mr. Bustamante, to comment on that later on if he wishes, because we're working on that subject at the Institute for Liberty and Democracy in Peru.

As you say, you can use any system to actually privilege someone. Traditionally in Peru, for example, the kind of ideas that are in the BGS paper, which are ideas I'm sure most would subscribe to—at least I subscribe totally—have been used for many years in my country to take advantage of the poorer sectors of the population. That is why we say progress is not only a matter of simplification, deregulation or decentralization; it is also a problem of how you make the rules, who makes the rules, who's responsible for them; they can't come from above, they've got to come from below. How do you incorporate them, and how do you maintain continual accountability of officials and politicians who have to implement these rules. Otherwise, they can be used to exploit people in the same way that socialism is being used by certain Latin American dictators to exploit their people. It doesn't matter what label you put on things, you can manipulate it. The important thing is that you be under popular control at all times.

And we are, of course, also studying alternative systems of justice and our whole preoccupation is how we can integrate what is functioning well in the informal sector into the formal sector and make it universally available and enforceable so that we can all work under the same rules.

What you stated is of enormous importance, I think. These are things that don't give immediate results over time when you implement these kind of reforms, but that's where it's at, that's where development is at.

MR. BUCHANAN: I want to share, in a way, Professor Bates' deep suspicion that many in the informal sector would not opt for a quick transition to the formal sector if they are given a choice, for the reasons he gave. That's my impression, and I'm just not convinced that it's that clear. And it's important for those of us who operate in the policy reform area to understand how deeply or how widespread that reluctance may be and the reasons for it. As Professor Bates has pointed out, in the process of policy reform we're trying to adopt or recommend policies that open economies toward greater participation by the informal sector. At least, that's the general thrust of our reform efforts. If we don't know just what their real attitudes are we could certainly get into trouble and make the job more difficult. I think it's an area that really has to be looked at and it's important for us to get a clearer grip on that choice.

MR. de SOTO: If I may comment also on what you said, Mr. Buchanan, and what Mr. Bates said before; this is a problem, the desire for change. Our experience in Peru has been the following one. At a general level Peruvians want to change. They want change because if we see who they voted for in the course of the last elections, they've always voted for political parties and systems that promise change, and they voted for them overwhelmingly. In 1985 the Peruvian vote went essentially at the end to APRA a la Garcia who promised radical change, and the other ones to the extreme left. The rightist parties, those who talked conservative arguments, were left with less than 18 or 17 percent of the vote.

The question, however, is that, as Mr. Bates pointed out, these people may want change because nobody is satisfied with the status quo that impoverishes them. What may happen is that once they have to react to their existing organizations, their leaders have a vested interest in that existence. Their leaders have been elected to perform the negotiations with the state, and therefore, if you take away the obstacles too fast, they'll find themselves unemployed.

That's why it is sometimes very difficult to act through informal organizations to implement change. You have to be careful about what ideas you bring through to them and how you work with them, because it's true there are a lot of vested interests.

In the case of Peru—I don't know of other countries—most people vote for parties who maintain a continual anti–status quo discourse. That may not be so in the rest of Latin America.

And as I run through my notes I see there was another question asked by a gentleman before on how much informality extends throughout the Third World or Latin America. I'd like to point out that in the last year since the book has been published we've been receiving a lot of mail and a lot of phone calls and visits of other people in Latin America talking about it. It seems to be a rather widespread phenomenon, but we can't really find this out objectively until we measure all these developing economies with the same systems and with the same methods.

But even in countries like Argentina, which I just visited recently to launch the book, I was surprised to find out that the leading statistics there on how big the informal economy was were that it's 60 percent of gross national product, and it refers to about 50 percent of the population.

It isn't a system like Peru's where the people that are in the informal economy by and large are generally the indigenous people who have moved from the countryside or from the rural area into the cities and not being able to integrate have created their own extralegal norms or their own communities; here it's rather a question of people moving from the formal to the informal sector. Because it isn't that Buenos Aires or any of the big cities have received large migrations of indigenous Argentines; I don't think there's that many in the country anyhow. It's mainly an Italian type phenomenon, which is that people of the formal sector are beginning to produce underground in the black economy like maybe they would in Italy or countries of the Mediterranean or, from what I understand, even the United States.

MR. CHICKERING: I want to comment briefly on Hernando's statement about the political allegiances of people in the informal sector and the problem I think it causes us in this country, many of us, in trying to fashion a political vocabulary that describes and understands what's going on in those countries.

The reason is that I think there is obviously, from this case and perhaps many others, a tremendous disjunction in the political vocabulary between substantive meanings attached to certain words and their metaphorical meanings. When we use the word "Marxist" or "Communist" in other countries or observe people voting Marxist or Communist, it's very tempting if not irresistible to impute substantive meanings that people who vote Communist are voting Communist for some substantive reason having to do with Marxist-Leninist theory.

But it's clear from the nature of Hernando's statement about the allegiance of large numbers of informals to the far leftist Marxist and Communist parties that the principal interest that they have in those parties really attaches to a metaphorical meaning of Communist, as a metaphor of outrage, a metaphor of protest against the status quo. And that really is confusing in our own attempts to understand what is going on in many places.

MR. SNODGRASS: I want to follow up on this point about what the economic interests of people in the informal sector might be; whether they benefit from reform or not. Policies and laws, as they affect the formal and informal groups, are different but not always to the disadvantage of what we've been calling the informal group. In some few cases there may be explicit favoritism, protection of different kinds for small firms, but very commonly there is implicit protection arising from the nonenforcement of taxes, regulations and laws, which produce what we call in our paper the small firm growth trap, which could be seen by the small entrepreneur as a very high marginal rate of taxation on—whichever way you want to phrase it—on firm growth or on coming out of the closet and becoming formal.

And we had a little example that we worked out for the Philippines which suggested just getting up to the point where you were paying sales tax and the minimum wage instead of a little less might require an 85 percent growth in profit at the margin. And in another meeting we had yesterday, Sue Goldmark produced an even more spectacular example from Honduras where all businesses legally must be registered, and one of the requirements of registration is that you pay all your back taxes, which of course could easily produce a marginal tax rate of hundreds of percents.

MR. de SOTO: I think that's very important. You mentioned it in your paper, what you call the growth trap. I'm glad to find a technical word for it because we called it, I think at the Institute in Peru, the Indian reservation syndrome. You create enough nice conditions at a lower level where you trap people at that level and you don't create that prosperous middle that you talk about.

And I share that preoccupation with you. In other words, I think the kind of work being done on microenterprises has had enormous cultural impact for enabling people to lose—I repeat, lose—their prejudice against poor people being able to lift themselves up by their own bootstraps or being adaptable to market systems and democracies and all the good things in life. So that's one good side.

The bad side of the emphasis on microenterprise is that it might encourage beliefs that what you really have to do is create a separate world for the informals, and that they really have cultural tendencies to be micro. "They're micro because that's the way they are," and "Peruvian Indians always have liked to have small enterprises," are the kinds of misconceptions that won't be changed so long as restrictions like the ones that Sue Goldmark has mentioned ensure that they will not have a chance to get into the bigger things.

That would be the danger: creating special legislation for poor people that goes beyond allowing them to demonstrate their capabilities in fact just replaces one set of obstacles with another. I share your concern.

MR. BUSTAMANTE: I want to make some comments derived from what John Grayzell told us of these trends in law. These comments probably will be perceived as sort of an attempt at simplification of the problem. But when we're talking about the case of the Peruvian mercantilist system, we're talking mainly about a very closed and inefficient state law which runs parallel to a very open and efficient and democratic set of extralegal rules—extrastate rules.

This attempt at simplification of the problem is the following. Let's build a legal system inside a whole legal system which would have the virtue of combining in the following manner these factors. This nationally planned legal system should be one in which we try to formalize what the informal institutions have been creating for a long time. As a matter of fact there is a concrete example, and this is the case of a district in Lima; this is a Communist-ruled local government in Lima, which has introduced into the local government very efficient rules that have been working for them over the 15 or 20 years that this organization has had the job. So in other words, they have transported the popular structural organization of the people in their group which invaded the land in 1967, to the municipal and local government structure. So in this case they are formalizing; this is a case of a Communist local government which tells us something important about politics, but they are formalizing that which has been and is informal.

But there is another important factor in this attempt at simplification which is the necessity of flexibility. In a certain way, informalize the formal rules because formal rules are closed and inefficient. So at precisely this moment all the rule making and things that Hernando de Soto has been talking about today take their true importance. I mean, the only way to make sure that the informal attitudes, the informal extralegal rules, are going to be incorporated in the system within a broad and more comprehensive legal system is to make sure that these informals participate in a very rigorous process of law making, to make sure of two things: the participation itself as a value that makes the rules richer, and the advantage of incorporating formally into the legal system a sort of filtered cost-benefit analysis to make sure that the input of people is going to be real feedback to rulers.

I want to make a reference to what has been asked today about the vote for Communists. In my country, it is a very clear thing that most of the informals vote Communist or—I think not for APRA in this case now—but would vote Communist because they feel that they are voting for change, and in voting for Communists and for change they think they are voting for denouncing, in a very clear way, state failures in providing them the legal structure that they need. So this is a second lesson in terms of policies.

Building policies which try to identify concrete and particular business interests of informals with denouncements or with fights against a state which is permanently avoiding its duty to integrate the informal economy would probably be the best possible way to proceed.

MR. EDWARDS: Over the last several years our Center has held a number of meetings in Latin America in which we've brought together think tanks and other representatives of institutions, and I can certainly report to you that the informal or underground economy is not an isolated phenomenon. We had people from Guatemala, from Brazil, from Argentina talking about as much as 10, 20, and what they said was as high as 30 percent of the economy which was in what they called the informal or the underground economy. Even in Nicaragua we have heard from our friends in Central America that the underground economy is growing because of the very natural human impulse towards freedom—freedom of an academic, intellectual, and economic kind.

I'd like to address a question to Dr. de Soto. One of the most interesting things that you've said is the need for public education if we're going to move an economy from the mercantilist to a more democratic way. (And apparently your book has been well received not only in your own country but in other countries in Latin America. I'm pleased to see that you're having a Portuguese translation so it will be available in Brazil.) I'm wondering if you could expand on that and tell us how public education about the importance and the role of the informal economy is being extended not only in your own country but throughout Latin America, not only in print but also in broadcast.

MR. de SOTO: We haven't really thought about the public education angle; we're only getting organized around it now at the ILD. First of all, the book is being sold in a way that greatly exceeded our expectations. We already have drafted a summary of the book, a synthesis for reading at more popular levels, and we're also designing a simplification of the book with drawings and other things. But we've seen already just in the last weeks that there are a couple of Mexican organizations that have already synthesized the book and are distributing it in Mexico. We're trying to get the rights to do it in Peru and elsewhere as well.

MR. CHICKERING: That's the entrepreneurial spirit.

MR. de SOTO: There's a lot of entrepreneurial spirit there. I think some elementary property right rules have been broken in the process, but these are the kind of rules that are welcome.

We're trying to set up in Lima a system of seminars where we would be receiving people from other Latin American countries and telling them how we did our things and give them a lot of the information which isn't published. We ourselves need some management techniques inside the ILD to see how we process a lot of our publications and make them available at more popular levels.

Of course, people of the ILD are participating in different television programs in Peru. We try to be present in most newspapers; we have at least one or two of the kids at the ILD writing in the editorial pages, and we've infiltrated most television programs in the country. And we have done so because we've always found that we are very welcome at, shall we say, the popular level. Our message doesn't have to go through those intermediate stages of organization which Mr. Bates mentioned before, those people who have the vested interest in reading our message in a different way, but we get directly to the public. We have much better results than from attending many public university conferences, for example. This has not been an unconscious practice because we always considered the intellectual community hostile to us, and it still is. We've always thought that we could achieve better results by getting way to the bottom and then having these people influence the people who for decades have been practically monopolized by Marxist-type thinking which really responds to frustrations, as Lawry Chickering was just pointing out.

So as you can see by the disorganized response I'm giving to you, we haven't thought much about it. We're doing a few things but we're not really organized other than for spreading the contents of the book. We also hope to organize a Latin American network of people interested in the informal sector who find that through the mobilization of the informal sector you can create a basis for the structural change that is called for in the BGS paper.

MR. LEWIS: I'd like to get back to the question of organization. I think it's most useful for me to try to use the terminology in the Landa paper and in Bob Bates' comments. What is interesting is where there is an organizational framework for people to begin to see collective benefits instead of private benefits. We've had some examples in the use of ideology and metaphor as some of these groups may attempt to get around their leaders to begin to accumulate—if I can use that word—accumulate collective benefits. And I'd just like to reflect a little bit of my own experience in A.I.D.

I've served in Africa and most recently in Haiti, and those countries have some similarities. But there was a major difference as you saw different niches and crannies in the informal sector begin to move or try to move from the accumulation of private benefits to the accumulation of some public goods, collective benefits. And I think the most striking difference was in Haiti. In Africa—well, Bob Bates is perfectly right—sometimes this process reaches a point and goes no further because of the vested interest in private benefits within the formal sector. Janet Landa talked about patrilineal clans; they are of course very vibrant in Africa as well. And they have their limitations as you try to move from a system of private law to public law.

But what was striking in Haiti was that the same energies would begin to coalesce, and they went much further in recent years, at least when I was there. I think the key difference was the presence of the Catholic Church; that there was an institutional framework that purported to do something about public goods in some vague way. This may seem like a truism, but if you look at it from a historical perspective, it just made all the difference in the world that there was a structure, a hierarchy of people who sometimes more, sometimes less, could bring people together with a kind of collective—however poorly defined—agenda.

Maybe in light of that experience we should look back to the beginning, before public law as we know it or common law or whatever began to operate for everyone and not just for some people; what sort of organizational entities were there to make this happen? Or what sort of organizational entities fell by the wayside, perhaps in the Latin American experience, where this stopped happening?

You may, in fact, get back to religious institutions again. So as we look back to Africa or Asia we may see an increasing alliance between religious institutions and this majority in the informal sector. Maybe we should look in that direction as we try to formulate, grope for, a useful policy.

MR. BATES: When you look at the history of the West where capital accumulation did take place and public goods such as drainage and tillage systems and irrigation were formed, historically they were formed first by the churches, so you're probably onto something, John. I wonder, however, whether the economic doctrines of the current Catholic Church are really going to help or hinder the kind of particular reforms we've been talking about today. I leave that for people who know more about that subject than I do.

We keep coming back to this idea of ideology and people's thinking as being a primary constraint, which as I've tried to argue, makes a lot of sense; that ideology is powerful now because uncertainty is so high and economists actually do so little for us in terms of knowing how to get from where we are now to where we want to be. We don't have good theories about that so things are up for grabs.

But regarding the idea of changing the way people think, I'm wondering if anybody who has experience in Latin America has tried to introduce into Latin American debates among the intellectuals contemporary thinking in Marxist circles in Europe, rather than Milton Friedman or Hayek, where the theories of Imperialism and dependency have been attacked by Marxists themselves.

I find some of the most effective critiques of the Left are by the Left itself, appearing in pretty darned good journals like the

New Left Review. Works by Brenner and Warren and others. And I think the potential for debate within the intellectual community is a resource for changing people's thinking on this issue that maybe is under-exploited. But I'd like to hear about that.

MR. de SOTO: I think Mr. Bates' point is well made; my first reaction is that if you would be so kind as to provide us a bibliography on Marxist criticism of the traditional theories by older Marxists it would be very welcome.

This I think relates somewhat to what Lawrence Chickering was talking about before in the sense that communism, which is the prevalent ideology at least in my country, is a metaphor or term of outrage. We saw this very much in the informal sector. I know that some of you are familiar, I'm sure, with our experiment in San Martine, but I will say a little bit about it for the benefit of those who are not.

There's an area in Lima with 500,000 inhabitants which is also a Communist-dominated area in terms of government. The leading party there is the PUM, which is one of the most radical wings of the Communist group of parties. And we were visited, I think it is now two years ago, in Lima by the mayor who told us that the council of nine people had reached a decision. And that was to solicit the collaboration of the ILD, of our institution, to help create their program for governing because their own party institution was incapable of giving them concrete programs. They had been reading the kinds of things we'd been putting out in the paper and those were the kinds of things they wanted to do. If we could get over any ideological distaste of dealing with them they would get rid of any ideological distaste of dealing with us.

So we agreed on that. We worked for about two months on creating a free enterprise zone in their area because we pointed out that 60 percent of the legislation which encumbered small enterprise in their area, which is what they were concerned about, was enforced at the municipal level. So municipal action could help to deregulate and simplify all of that legislation.

We agreed on creating basically a pilot free enterprise zone which we called something else like Popular Action Zone for the Rights of Poor People or something like that; it doesn't matter what the title was. But we did design one, and then when the agreement was signed and came to light there were a lot of photographs in the papers; but there was one big ad to indicate that we agreed on sort of ten commandants, which I'm sure the Hoover Institution could agree with, and so did the Communist mayor, by the way, and he signed and we signed and everybody was very happy about the whole thing. Of course, everybody except the central committee of the PUM, which hadn't gotten word of this, and they reacted immediately and called in the mayor and browbeat him into making a public confession, or auto criticism, which is what they do in Cuba. And he had to come out. And when he did, the three other members of the PUM who were on his council and who gave him a majority resigned from the PUM, and the three in one degree or other are working with us now at the ILD.

So when we asked for an interpretation of this from an American political scientist who knew Peru rather well he said, well, this indicates that the Communists in Peru are ideologically soft; what they basically want is change. The reason most people that want change happen to be members of one or another extreme left party is because they're the only ones who continually talk about change. It's enough that even a puny little institute like ours utters the same sort of sounds they do, even if it's in another direction; they're willing to try something new. So that's why I think that political involvement is important, because all desires for change now in Latin America are identified in one way or other with extreme left parties. They could just as well be identified with people who I'm sure think like most of the persons around the table, we're just not ideologically present or haven't been until very recently.

MR. SPILLER: It seems to me there is a misunderstanding of what de Soto's work is, both in Landa and in the BGS piece. The problem of the informal sector in Peru is not that they are not able to develop their own legal norms. They develop their legal norms, as well as the traders in diamonds in Belgium and Tel Aviv develop their legal norms. Those are norms that, in the case of the traders, are the efficient norms. No one can complain, I think, in Belgium or in Tel Aviv that the legal system discriminates against Jews that operate in diamonds. That's wrong.

The problem is that here we have these very continuous transactions which are very personalized because you are continuously dealing with the same individual, giving him diamonds, and he gives you money and gives you diamonds back as well, and this relationship is very repetitive. In these circumstances, you just cannot use the legal system as efficiently as you want to in resolving contractual problems.

The best legal system cannot do it, so you have to figure out ways to enforce contracts. And one way to enforce contracts is by doing it with your friends, being able to impose some ostracism, and that works in those circumstances.

The problem in Peru with the informal sector is therefore not the same as the problem with the traders. The problem there is that you have a set of people for whom the efficient way of organizing is through using the law, but the law is not accessible to them. So they have to develop ways that make them small, unable to invest in specific assets, and inefficient. But that is totally different from the other forms of organization which are clearly efficient forms. This is an inefficient form but it's not inefficient by choice. It's inefficient by restriction.

MS. LANDA: I do not believe that I have misread de Soto's paper. De Soto emphasized that the inefficiencies of laws in the formal sector—the high costs of compliance with the labyrinth of rules and regulations—force many individuals out of the formal sector. Fortunately, these people are able create extralegal norms as a substitute for formal laws, to facilitate them in their economic activities in the informal sector.

De Soto's work is meant to draw attention to the dynamism and vitality of entrepreneurship in the informal sector. But de Soto clearly sees the existence of the extralegal norms in the informal sector as a second best solution to the development of entrepreneurship and markets in Peru and other Latin American countries. The absence of efficient formal laws—property, contract, and tort laws—to facilitate entrepreneurship makes it necessary for the informals to cooperate on a tribal basis with close family members, hence limiting themselves to "artisanal production and small firms."

The policy implication for promoting efficient performance in the formal and informal sectors is the creation of a set of efficient laws which will lower transaction costs so as to bring the informals back into the formal sector.

In analogous fashion, my paper focuses attention on the high transaction costs of entrepreneurs operating in an environment in which the legal framework for the enforcement of contracts is not well developed. In order for middleman entrepreneurs to operate successfully in such environments, they must, in addition to their usual middleman functions, perform the gap-filling role of enforcing contracts. This explains why successful middleman entrepreneurs in less developed economies of Southeast Asia and Africa are found in foreign ethnic groups whose social structure emphasizes mutual aid and cooperation among members of the same kinship or ethnic group. The codes of ethics of mutual aid embedded in these ethnic groups provide the basis of mutual trust which sustains the continuous dealings over time without the need to resort to formal contract law for the protection of contracts.

I show, in my paper and in my discussion, that even this arrangement which is efficient relative to the context in which the middlemen are embedded, is inefficient when we take account of the costs of exclusion of outsiders. In other words, the size of the middleman group seen as a trading club is smaller in a world in which the legal framework for contract enforcement is not well developed compared to an optimal size club composed of both insiders and outsiders. Thus the existence of efficient contract law will expand the size of the trading group to include both foreign and indigenous middlemen. Furthermore, as Robert Bates has pointed out, the legal systems I have analyzed may provide the public goods which support an active and efficient informal commercial sector; but they are less likely to provide the legal infrastructure which will safeguard large-scale, productive investment and thereby generate rapid industrial growth.

Thus, both de Soto and I emphasize the dynamic element of entrepreneurship in the informal sector; and we both emphasize the need for a set of efficient legal institutions for generating a greater supply of entrepreneurship and promoting economic development.

One final point. It is not obvious that the legal system cannot be used as efficiently for resolving contractual problems arising from continuous transactions entailing a great deal of trust, as in the diamond trade. If we find that the diamond traders in present-day Antwerp, Tel Aviv, or New York rely on personalized relationships for the enforcement of contracts, it is not necessarily because the legal system cannot be used as efficiently for resolving contractual problems. The Jews long had a monopoly of the diamond trade, a monopoly due to their ability to enforce contracts among themselves in the days when formal contract law was not well developed.

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Tyler Biggs, Merilee S. Grindle, and Donald R. Snodgrass

The Informal Sector, Policy Reform, and Structural Transformation

Introduction

The Current Enthusiasm for Informal Sector Programs. A lot of people have discovered the informal sector in recent years. In thinking and writing on economic development there has been what Judith Tendler aptly describes as "a remarkable convergence of fashion on the small enterprise and the informal sector" (Tendler, 1988). Neoclassical economists have decided that this part of the economy uses combinations of labor and capital that are "right" for the national factor endowments—unlike the large and formal sector firms, which are induced by government policies to use excessively capital-intensive and "modern" techniques. Agricultural economists, seeking to reemphasize the importance of agricultural growth, stress that linkages between agriculture and the smaller nonagricultural enterprises can be strong and mutually reinforcing. Meanwhile, specialists on both small-scale enterprise and the informal sector have emerged, arguing that these sectors provide livelihoods to large numbers of people, many of them poor, at levels of pay and productivity not necessarily inferior to those generated by large-scale formal sector firms.

While a wide range of opinion therefore agrees that small-scale enterprises and the informal sector are important (for one reason or another), Tendler correctly notes that this convergence of thought has not yet led to a similar consensus on the question of policy—how best to realize the potentials represented by small-scale enterprises and the informal sector. At least five overlapping but reasonably well-defined schools of thought can be identified (Tendler, 1988).

(1) One school defends the programs of direct assistance targeted on small and informal firms that have long been undertaken by many developing country governments and international assistance agencies. It argues that these firms need preferential access to credit, training, and other forms of assistance if they are to survive and grow. They merit this assistance, the argument runs, because they support so many people, provide goods consumed by the poor, offer a channel for entrepreneurial development, and encourage geographical dispersion of economic activity.

(2) Neoclassical economists criticize this line of reasoning, contending that direct intervention by Third World governments through policies and programs targeted on small or informal firms lead to inefficiency and distortions (Little, Mazumdar, and Page, 1987). What they should do is remove policy biases against small and informal sector firms, in the popular phrase "level the playing field" on which they compete with larger, formally organized firms. Targeted programs and policies are not justified, the neoclassical economists argue, by any clear-cut superiority with respect to achieving increases in productivity or equity. The scale of enterprises operating in any particular sector should be left to the work-

ings of the market, once policy liberalization has permitted the market to work.

(3) A third group maintains that while direct intervention is merited, at least as a form of direct assistance to the poor, the government is neither able to provide effective assistance to the informal sector nor, in many cases, willing to do so. This group notes that the informal sector works largely outside existing laws and regulations, using techniques that government officials may not recognize, condone or even, perhaps, understand. The required assistance should therefore be provided by nongovernment organizations operating in an irregular, nonbureaucratic style.

(4) The argument that the government would not even want to assist the informal sector is based on a view of the informal sector as complementary to the formal sector and very much in the interest of the local elites, who control the formal sector and are influential in the government. In this view, the informal sector provides a pool of low-wage urban employment that can be drawn on as needed to supply labor to formal sector firms. The government would therefore not want to develop or eliminate the informal sector.

(5) A potential fifth group, for which we are recruiting, accepts the neoclassical economists' criticism of targeted programs and policies but tries to improve on their policy recommendation. As Tendler observes, the rapid growth of the economies of East Asia is currently being reinterpreted as having involved much more government intervention and less reliance on markets to allocate resources than had been thought previously. South Korea and Taiwan were able to promote the development of small and medium enterprises in ways that forced them to perform and limited the growth of rent-seeking behavior. We are currently reexamining the experiences of some of these countries to see what principles of constructive intervention can be formulated to promote the rapid growth of an efficient, labor-absorbing industrial sector.

Tendler's "remarkable convergence of fashion" is not limited to the scholars. Increased attention to small-scale enterprise and the informal sector is also evident in the worlds of politics and action. Aid donors, political activists and developing country governments have all joined in. In the United States a remarkable political coalition, stretching from end to end on the right-left spectrum, is backing the proposition that informal sector activities in the developing countries should be promoted more vigorously through small business loan projects funded by A.I.D. Conservatives see in this proposal opportunities for expanding entrepreneurship, creating jobs among the poor to help ensure political stability and strengthening the private sector, which they believe to be the true motor of economic development. Liberals support the same measures, seeing in them a grass-roots, participatory way to help the poor, a means of generating self-sustained development among poor people to help them escape from poverty.

Governments in many developing countries have also become increasingly interested in the informal sector because of the large number of people whom it supports. At a time when many countries are experiencing severe economic dislocations, governments are concerned about the political consequences of economic crisis and are looking to promotion of the informal sector as one way to increase employment opportunities for poor people (see, for example, Sanyal, n.d., pp. 2–3).

In this paper we argue (1) that the "remarkable convergence" of views on small-scale enterprise and the informal sector is to some extent based on misinterpretation, and (2) that some of the policy inferences that have been drawn are wrong. We first lay out our objections, then present an alternative viewpoint.

The Definitional Problem. Reexamination of the prevailing consensus starts with the definition of the informal sector itself. Careful examination reveals the term "informal sector" as a heuristic device at best. According to the International Labor Office's 1972 report on Kenya, which is widely credited with popularizing the term, "informal activities are the way of doing things, characterized by:

(a) ease of entry;

(b) reliance on indigenous resources;

(c) family ownership of enterprises;

(d) small scale of operation;

(e) labor-intensive and adapted technology;

(f) skills acquired outside the formal school system; and

(g) unregulated and competitive markets.

These "activities are largely ignored, rarely supported, often regulated and sometimes actively discouraged by the government."

Logically enough, "the characteristics of formal sector activities are the obverse of these, namely,

(a) difficult entry;

(b) frequent reliance on overseas resources;

(c) corporate ownership;

(d) large scale of operation;

(e) capital-intensive and often imported technology;

(f) formally acquired skills, often expatriate; and

(g) protected markets (through tariffs, quotas and trade licenses)" (ILO, 1972, pp. 6).

Problems arise because the characteristics which are bundled together in these definitions may be found together but may also occur separately. For example, those who emphasize the status of the enterprise in relation to law and regulation insist that size is no criterion; by their definition, informal sector firms may be quite large (de Soto, herein). But others put the emphasis on enterprise size, usually measured by the number of workers involved. Ray Bromley brings out the ambiguities by listing no fewer than nine "particular deficiencies that are worth mentioning" in "the informal/formal classification, as commonly depicted in the literature" (Bromley, 1979, pp. 1034–35). A recent review of the literature comments that, notwithstanding hundreds of academic pages devoted to the task, popularizers of the informal sector concept have been "unable to come up with a definition precise enough to be useful for analytical or operational purposes" (Richardson, 1984).

Presented with an enormous quantity of research with differing results depending on the definitional approach adopted, both policymakers and development practitioners find it difficult to respond appropriately to calls to stimulate the growth of the informal sector. It is next to impossible to target that which cannot be defined. Is it workers or is it firms that policymakers should worry about? Is it the broad aspects of poverty which should be directly targeted? Or is it the institutional setting that deserves most attention—namely government regulatory agencies and the legal system?

Much of the interest in "informal" economic activity in developing countries stems less from the importance of informality itself than from the fact that activities classified as informal tend, on the whole, to exhibit low productivity (Peattie, 1980).[1] This problem, as we see it, arises because during the course of economic growth and transformation in many less developed countries (LDCs) certain segments of the work force and enterprise population seem to get stuck in low-productivity economic activities in industry and services. This suggests that questions related to the informal sector (however defined) cannot be studied in isolation from the rest of the economy but must be addressed in the context of the structural transformation problem. A holistic, evolutionary analytical framework is required. We need to ask what determines the nature and speed of structural transformation and how these outcomes are affected by market and policy-induced failures.

We propose to refocus attention away from the informal sector as such and directly on the causes and consequences of low-productivity employment. Empirical data indicate that the pattern of "distorted" and/or "unsuccessful" structural transformation can be traced out both in the labor market and in the size distribution and productivity of industrial enterprises. In this paper we analyze both of these aspects of the low-productivity employment problem, with special emphasis on Latin America.

An Alternative Viewpoint. To assist the reader, we will close this introductory section by summarizing our main points. For countries at low and middle levels of per capita income, substantial improvement in living standards requires economic growth, the essence of which is rising average income levels. All the important indicators of social welfare are positively correlated with per capita income; in most cases the degree of correlation is high. The distinguished research of Kuznets (1965; 1966) and Chenery (1979; Chenery and Syrquin, 1975) demonstrates conclusively that, except in countries which possess fabulous mineral wealth, economic growth requires structural transformation. This involves a rise in the importance of the industrial sector, both in absolute terms and as a share of aggregate value added and employment. As structural transformation occurs, the importance of the agricultural sector declines. The service sector may rise or fall as a share of total production and employment.

Besides these changes in the relative importance of the three main sectors of the economy, structural transformation also involves important changes within each of these sectors. Within the industrial sector, one of the changes which takes place is a shift from a bimodal distribution of employment in terms of enterprise size—one in which there is a mountain of workers employed in small enterprises, a low valley in medium-scale enterprises, and a smaller peak in large enterprises—to a unimodal distribution (a single peak and a larger average firm size). In countries at low levels of per capita income, small or "informal sector" firms account for as much as three-quarters of industrial sector employment, but a much smaller share of value added.

Structural transformation within the industrial sector has two components: a "labor reallocation" component, in which people who are working on their own or in small enterprises eventually find higher paid jobs in larger firms, and an "enterprise growth" component, in which a very small number of small enterprises grow into the middle and larger size categories. Quantitatively, the "labor reallocation" component is by far the more important. As emphasized in the "dualistic" models of Lewis (1954) and Fei and Ranis (1964), development occurs largely through the shift of labor to more productive forms of employment. As *not* stressed by these theories, these shifts take place not just between agriculture and industry but also within the industrial and service sectors. Although smaller than the "labor reallocation" component, the "enterprise growth" component is also significant. A dynamic economy permits successful small firms to grow into the middle size category and middle size firms to become large. While most small firms fail after a few years or remain stagnant, merely earning a living for their proprietors, a few grow and add an important element of dynamism to the economy (Storey et al., 1987).

Although Chenery and others have identified "normal" or average patterns that tend to apply to countries at particular levels of per capita income, there are also substantial variations among countries at similar income levels. Some of these are caused by differences in "givens" such as natural resource endowments, while others result from differences in economic policy.

Many LDCs exhibit the extreme dualism in the distribution of industrial sector employment in terms of enterprise size which we call "the missing middle." We attribute this to policies that favor the largest firms, on the one hand, and in some cases also the smallest ones, on the other. Although we do not believe that enterprise size provides a satisfactory basis for discriminatory policy measures, this type of industrial policy can be harmful because it creates a "small firm growth trap" and inhibits the "enterprise growth" component of structural transformation. To shift labor to higher productivity activities, it is necessary to promote growth and labor demand. This in turn requires promotion of the most productive growth agents in the economy.

Even if the GNP of Bangladesh, Burkina Faso, or Bolivia could be distributed in equal proportions to the citizens of those countries, they would still be very poor. The only way to overcome their poverty is through economic growth, and this requires structural transformation that moves labor from less productive activities to more productive ones and permits the progressive minority of small firms to grow.

Several principles of economic policy flow from this argument. First, to the extent that scarce resources have alternative uses for the promotion of economic growth and structural transformation, their use in programs aimed at direct amelioration of poverty is likely to yield smaller gains and thus should be held down. Where potential clients are small and numerous, the administrative costs of direct aid programs may be prohibitive.

Second, enterprise size is not a useful guide to policy determination—if for no other reason than that optimal firm size differs among industries, by market size, between open and closed economies, and by levels of development. In most countries, policy discriminates in many ways in favor of large, "formal" firms controlled by the national elite. Among the many unfortunate effects of this pattern of discrimination, which usually occurs within the context of an effort to substitute local production for imports, is the reduction of growth opportunities for firms of small and medium size. In many cases, small or "informal" firms are actively suppressed on the grounds that they are not modern. This is clearly undesirable; the only acceptable basis for such suppression is the limited number of cases (drugs, prostitution, etc.) in which "informal" economic activity poses a direct threat to public order.

Third, however, policy must go beyond mere neutrality—"the level playing field"—to active promotion of potentially dynamic firms. Despite the frequent advocacy of policy neutrality by the World Bank and others, no country yet has developed on this basis. To fill in "the missing middle" countries must be able (a) to formulate policies that are performance-based and permit progressive, dynamic small and medium sized firms, in effect, to identify themselves, and (b) to provide the forms of assistance that will help these firms grow. How to accomplish these two tasks is not yet altogether clear, but the general principle is that what is needed is not policy neutrality but policies which favor firms that turn in favorable performances.

The Informal Sector and Labor Reallocation in Structural Transformation

"Soft" vs. "Hard" Employment. At the heart of the problem of low-productivity employment is the notion of "soft" (or labor-supply-pushed) employment versus "hard" (or rest-of-economy-pulled) employment. "Soft" employment (sometimes called under-employment) results when long-run labor supply runs ahead of long-run labor demand, pushing labor into particular sectors that are then forced to "sponge up" excess labor in the form of low-productivity jobs. For example, in the service sector, more shoe-shine boys and street vendors appear, driving down returns to these activities. In manufacturing, surplus labor may be indicated by "traditional" lower productivity technologies surviving longer than they should, as small producers are forced to eke out a living at the margin. "Hard" employment, on the other hand, is demand- and productivity-driven. Jobs are created as economic growth proceeds. The demand for labor in this case outstrips supply in various sectors, pulling labor into higher productivity activities with higher relative factor rewards.

There are proximate causes (on the demand side) for "soft" supply-pushed employment, each requiring a different target for policy interventions to correct it. First, "soft" employment can be caused by insufficient aggregate demand—the Keynesian employment problem. This is generally only a short-run explanation, although very important in recent years with the debt crisis. Second, employment can be severely affected by price distortions. In factor markets, wages are often out of line with full-employment equilibrium rates, causing insufficient demand for labor. In financial markets, controlled interest rates make capital costs artificially low in relatively capital-scarce countries, leading to overly capital-intensive production technologies. Product-market price distortions may be responsible for even greater labor dislocations. The terms of trade between industry and agriculture are particularly important. Third, nonprice distortions are a significant cause of labor demand problems. Malfunctioning institutions, such as poorly operating credit intermediaries, red-tape plagued government agencies, and distributional distortions, such as unequal land distribution, can reduce the demand for labor.

Coupled with increasing growth rates of the labor force, each of these demand-side factors has played a role in models explaining the problem of low-productivity employment in urban areas of Latin America. Two models have been particularly important in the region: the ECLA model and the Harris-Todaro model. ECLA represents the "structuralist" view, which emphasizes nonprice distortions. The Harris-Todaro Model represents the neoclassical view, emphasizing price distortions.

ECLA argues that land is artificially scarce in Latin America because it is unequally distributed. High growth rates of rural population combine with this artificial land scarcity to push labor into the cities. In the urban areas, labor supply grows faster than demand because industrial technologies, largely imported from advanced countries, have high and fixed capital coefficients. "Soft" employment increases, particularly in the service sector. The policy recommendations that follow from this view of the low-productivity employment problem involve removing the nonprice distortions by initiating land reform and reducing technological dependence on more advanced countries.

In the Harris-Todaro model, inappropriate urban wage policies (minimum wage laws, government wage rates, and the wage policies of multinational corporations) create a large differential between urban and rural wage rates. This encourages rural-urban labor migration, which is limited only by the probability of actually getting an urban job. A sort of lottery of well-paid urban jobs develops, urban labor supply increases faster than labor demand, and "soft" employment results in the service and manufacturing sectors when many of the migrants fail to obtain the high-paid jobs they seek. The policy recommendation in this case is to reduce the factor-price distortion, for example by modifying minimum-wage laws and government hiring practices.

Whatever causes "soft" employment to increase in a particular case, the situation can be made worse by an inappropriate government response (Gelb, Knight, and Sabot, 1987). In many countries, government has tried to offset rapidly growing urban labor supply by expanding employment in the government and public corporations. Often deficit financing has been used to meet the higher payroll that results, with untoward effects on inflation, balance of payments and, in the longer run, the rate of economic growth. Since public sector activities are frequently less productive than private sector activities, a "public sector sink" can emerge, into which increasing amounts of government resources are poured. As these unproductive resource allocations grow and deficit financing taxes the private sector through rising inflation, economic growth suffers. This reduces the aggregate demand for labor and increases the "need" to create unproductive employment in the public sector.

An important lesson to be learned from these models is that "soft" employment can stem from distortions in any sector of the economy. In the end, the maldistribution of labor caused by these distortions is traced out in an unbalanced process of structural transformation. The problem of "soft" employment thus requires a more complex solution than that personified by a simple programmatic "fix" aimed directly at street vendors. Structural problems, be they maldistribution of agricultural land or distortions in factor and product prices, must be removed or at least reduced. A later section of this paper will discuss the problems involved in trying to bring about such policy reforms.

Employment Growth and Urban Surplus Labor in Latin America. What do the data tell us about recent trends in urban employment in Latin America? Do they indicate a growing amount of "soft" employment in all or part of the region? Has modern industrial labor absorption generally been too low to soak up a burgeoning urban work force? And has over-urbanization contributed to the marginalization of large segments of the economically active population?

Advocates of the informal sector concept argue that rapid urbanization and low industrial labor absorption have pushed labor into low-productivity jobs rather than open unemployment (Mazumdar, 1975; Souza and Tokman, 1976; Sethuraman, 1977). In Latin America, "formal" segments of the industrial sector are often accused of not absorbing enough labor. An examination of structural changes in Latin American employment is instructive in assessing this assertion.

Almost all the Latin American countries deviate from the "standard pattern" of economic structure at different levels of development, which emerges from the work of Chenery and associates, by having a lower share of employment in agriculture than is typical of countries at their respective income levels.[2] They also derive less value added from primary production.

Related to this low agricultural share are rapid urban labor force growth and a high level of urbanization. While the total population of Latin America grew at 2.6 percent per year between 1950 and 1980, the urban labor force grew at 4.1 percent (Table 1). Consequently, Latin America has become one of the most urbanized regions in the world, exceeding the expected degree of urbanization for its income level by 14 percentage points.

Since the percentage of employment in industry in Latin America does not differ much from the standard pattern (except in Venezuela, Argentina and Chile), employment in the service sector is necessarily larger than predicted (Syrquin, 1987). The service sector has had to soak up much of labor moved out of agriculture. The unbalanced absorption of labor to services as structural transformation proceeds is no great surprise. Thirty years ago Kuznets found that ". . . in most countries the substantial decline in share of agriculture is compensated by a substantial rise in share of services, not by a rise in share of industry" (Kuznets, 1966).

Table 1
Growth of Population and Employment in Latin America, 1925–1980
(Average annual growth rates, percentages)

	1925–1950	*1950–1970*	*1970–1980*
Population			
Total	2.2	2.8	2.5
Urban	3.5	4.4	3.8
Economically Active Population			
Total	2.0	2.3	3.0
Primary	1.4	1.0	1.1
Nonprimary	2.9	3.6	4.2
"Formal" (industry)	—	3.7	4.1
"Informal"*	—	1.5	2.1

Distribution of Economically Active Population (percentage)	*1925*	*1980*
Primary	62.3	35.9
Manufacturing	13.7	18.3
Other Sources	24.0	45.8

*"Informal" is defined generally as self-employed plus unpaid family workers.
Source: Ramos 1984 based on ECLA 1965 and PREALC 1982.

The Rate and Structure of Urban Industrial Labor Absorption. Does the large shift of labor from agriculture to urban tertiary employment in Latin America imply a failure of modern industry to expand employment opportunities? Evidence indicates that this was not the case in most countries.

In general, annual growth rates of industrial employment in Latin America kept pace with the growth of the economically active nonagricultural population between 1950 and 1980 (Ramos, 1984, based on ECLA, 1965 and PREALC, 1982).[3] These growth rates, in fact, were analogous to those of more developed regions during their periods of rapid structural change and development (Kuznets, 1966; Tokman, 1982).

A number of countries had especially rapid growth of industrial employment: in Brazil modern industrial employment grew at an average annual rate of 4.3 percent, 1950–80; in Mexico the comparable average was 5.0 percent. Pulling down the regional average were countries such as Peru (2.8 percent average annual growth), Chile (2.3 percent), Argentina (1.7 percent) and Uruguay (0.9 percent) (ECLA, 1985). The main reason for this significant increase in industrial employment was the growth of industrial product over the period. In most countries growth in industrial output was fast enough to absorb the large inflow of labor supply from the rural sector.

Data on the rise of sectoral productivity over the 1950–1980 period generally confirm that the growth of urban employment was driven by demand rather than supply. "Excessive" growth of the service sector (an increase in "soft" employment) would have led to falling productivity. In fact, productivity in the service sector rose at an average of nearly 2 percent a year over the three decades (Table 2). There is also evidence that the fastest growing jobs in the service sector during this period were for qualified nonmanual employees—professionals, technical, and clerical (Ramos, 1984, p. 74). There is no indication that average real wages in tertiary employment declined in the observed period. Nor did average wages in other urban activities, such as construction and activities designated as "informal," decline over the period (Ramos, 1984, p. 74; Gregory, 1986; Pfefferman and Webb, 1979). No large increase in marginal employment can be detected.

The Problem of Structural Heterogeneity. That Latin America as a region realized much greater amounts of industrial labor absorption than acknowledged by many observers, particularly the informal sector enthusiasts, does not mean it had no employment problems. Despite the positive trend, there were problems in some periods and in some countries. Peru, Argentina, and Chile saw significant increases in "soft" employment in the service sector during the 1970s and early 1980s. In Chile and Argentina the problem was caused by neoconservative stabilization and liberalization policies; in Peru, by a severe recession in 1975–78. Several countries experienced large regional imbalances and a kind of metropolization of the labor force. But the most disconcerting aspect of

Table 2
Productivity Growth Rates 1950–1980
(percentages)

	1950–1960	*1960–1970*	*1970–1980*	*1950–1980*
Primary	3.3	2.3	2.4	2.6
Industry	2.8	2.8	2.3	2.7
Tertiary	1.0	2.2	2.1	1.8
Total	2.9	3.1	2.9	3.0

Source: PREALC 1982 quoted in Ramos, 1984, p. 74.

employment growth in Latin America has been the persistence of structural heterogeneity—the fact that much of the urban economically active population continues to work in low-productivity activities, often side-by-side with high-productivity activities in the same sector. This has meant that conditions of employment have stagnated for a large segment of the urban work force.[4] The central cause of structural heterogeneity, particularly its persistence over time, is inappropriate public policy.

By the early 1980s estimates put urban low-productivity employment in Latin America at 30 to 40 percent of the total, depending on how low productivity is defined. This figure is similar to estimates of the proportion of "informal" workers in the United States and other developed countries for comparable historical periods (1900–1930) (Tokman, 1982). But there is a difference between the employment structures of low-productivity activities in the two cases (Table 3). In the United States in the early 1900s, "informal" employment was concentrated in service activities. In Latin America it is equally distributed between manufacturing and services. The proportion of low-productivity labor in Latin American manufacturing is pronounced and seems to be stable over time. In the United States, self-employment in manufacturing was relatively small by 1900 and declined substantially over the next three decades.

As industrial growth accelerates and structural transformation of the economy proceeds, employment in the informal segment of manufacturing usually decreases. There are two reasons for this. First, modern technology (usually imported), which is the engine of indus-

Table 3
Comparison of the Structure of Urban Employment in Latin America (1950–1980) and the United States (1900–1930)

	"Informal" workers[a]	*Self-employed*[b]	*Self-employed in manufacturing*[c]
		Latin America	
1950	46.5	27.3	22.1
1960	44.8	28.1	21.5
1970	44.0	28.3	20.7
1980	42.2	—	—
		United States	
1900	50.8	34.0	7.2
1910	41.8	29.3	6.0
1920	34.5	26.1	4.4
1930	31.2	23.1	3.0

[a]Percentage of the total labor force. Informal workers are defined as the sum of the self-employed, unremunerated family workers, and domestic servants.
[b]Percentage of the total labor force.
[c]Percentage of the manufacturing labor force.
Source: Portes and Benson 1984 taken from PREALC 1982; Tokman 1982, Table 4; Lebergott 1964, Tables A3 and A7.

trial development, should increasingly displace the majority of traditional, artisanal, and other low-productivity methods. Second, the absorption of labor into more modern production should affect first those workers with training and occupational skills. Self-employed artisans are generally among the most skilled workers available. The fact that the share of self-employed persons in manufacturing remained constant over 30 years means that the absolute number of such people increased by at least 1.8 million workers (Portes and Benson, 1984). In the face of reasonably rapid rates of industrial growth, a decline in this segment of the work force would have been predicted. What has occurred, therefore, is a suspension of the process of efficient structural transformation in production.

Suspended structural transformation is the result of policy choices which have important historical, institutional and political antecedents. A short list of some of the economic policies that have shaped structural transformation in Latin American countries would have to include the following:

- chronically overvalued exchange rates;
- high levels of effective protection;
- high taxes, combined with measures of tax relief which encourage the use of capital;
- labor protection laws that are favorable to unions, but detrimental to labor, generally;
- financial market policies which include controlled interest rates and selective credit controls; and
- pervasive government regulations on all kinds of economic activity.

These policies have impeded growth and structural transformation of the economy along a path that would continually shift workers to economic activities with higher levels of productivity and have distorted incentives in such a way that low-productivity employment becomes an efficient mode of production—in some cases, perhaps the only possible mode of operation.

The policy environment has been responsible for at least two important distortions in labor markets that have influenced the structure of economic activity.

First, wage rigidities have been created by labor laws, government regulations, and union activities. In many countries, laws that provide expensive forms of insurance for contractually hired workers and protect them from dismissals during downturns in economic activity have made employers reluctant to increase the number of contractually hired workers, since this raises costs and decreases managerial flexibility. Instead, they rely more on the highly elastic labor supply that is accessible through two channels: direct hiring on a casual basis (*eventuales*) and subcontracting of production and marketing services to small establishments or households (Portes and Benson, 1984). These types of labor utilization make it possible for "modern" manufacturing (and service) establishments to pay "traditional" wages. The popularity of these devices leads to a distortion in the employment statistics, since many of those who are de facto employed by modern industry are recorded as engaged in "informal" activities.

Second, policy-imposed distortions have impeded technological improvement by increasing the cost of modernizing and expanding firms (Nelson, Schultz, and Slighton, 1971). Slower adoption of new technology increases the survival space for less efficient, more traditional enterprises (Winter, 1964). Managers are thereby insulated from the need to upgrade their production techniques and eliminate low-productivity economic activities. When incentives are severely distorted by policies and regulations, the process of growth and structural transformation can become stalled.

Society loses when the shift of labor to more productive uses and more efficient units of production is slowed down. One study of Colombia measured the economic returns to shifting labor from lower to higher productivity firms within an industry as 20 to 30 percent of the reported increases in value added per worker for the period 1958–1965 (Nelson, Schultz, and Slighton, 1971). If the benefits to be gained from shifting labor to higher-productivity sectors by removing policy-induced distortions in factor markets were added in, the potential gains would be even more impressive.

Implications for Policy Goals and Programs to Deal with the Informal Sector. First, there is no getting around the fact that economic growth is a decisive factor in eliminating supply-pushed, low-productivity employment. Rapid growth in industrial value added is a lot like riding a bicycle—the faster it goes the more stable it gets. In fast-growing economies, many problems are self-correcting—resources are reallocated more smoothly, both within and between sectors, and real wages are pulled up by the general rise in the aggregate demand for labor.

Second, the forces that come together to create urban employment problems are conditioned in complex ways by economy-wide development policies and institutional problems. The way in which agriculture develops, the initial levels and pace of human capital development, and the effects of trade policies, to name a few, all play a role. Considering the complex interactions of forces affecting low-productivity, "informal" employment, it is facile to think that a "policy fix" aimed at solving the problem directly at the microeconomic level is the answer. The problem must be addressed at both the micro- and the macroeconomic levels.

Third, the size of the self-employment sector is less troubling than its *composition* and the *stability* of such employment. To address these problems, policy and program interventions must aim at removing distortions that have driven the economy away from efficient growth. Instead of perpetuating structural heterogeneity, policy and program interventions should foster a more efficient structural transformation by stimulating economic growth and smoothing the way for effective adjustment of resources to accommodate the growth process.

Fourth, with rapid urbanization and a policy regime that benefits only a limited number of workers, an individual's choice of "informal" employment in industry may be rational and efficient in the short run. In the longer run, however, substantial economic and social gains depend on the achievement of much higher productivity levels through the creation of more efficient units of production. As these units are created, labor will be drawn into more highly organized sectors of the economy, where there is better protection of property and contractual rights and higher wages and benefits.

The Informal Sector and Enterprise Growth in Structural Transformation

Firm Size Distribution and Economic Development. The size distribution of industrial enterprises is systematically related to levels of economic development. Broadly speaking, there are three stages. In the first phase, household and cottage-shop manufacturing predominates, accounting for 50 to 75 percent of total manufacturing employment. In the second, small and medium workshops and factories emerge at a comparatively rapid rate and replace cottage-shop manufacturing in many sectors. In the third, large-scale production becomes predominant, displacing the remaining cottage-shop activities and much, but not all, of the workshop and small-scale production (Anderson, 1982). None of these phases, however, is distinct. Countries move gradually from one stage to the next, and the rate of change is likely to differ among industrial sectors and regions of a developing country.

The forces which drive the organization of manufacturing activity through these phases and thus determine, in large part, the firm size at any given time are extremely complex. Among the most important influences are (1) rises in per capita income and resultant changes in patterns of domestic demand, (2) the development and adoption of new technologies, and (3) the influence of government policy on these two variables.

Increases in per capita income alter the mix of industrial sector outputs demanded. Over time, there is likely to be a shift toward more sophisticated products, which are most efficiently produced by larger firms (i.e., products for which there are economies of scale in production). This causes the structure of manufacturing activity to shift toward larger firms.

On the supply side, changes in technology may also lead to production by larger firms. Adoption by poorer countries of technologies developed in richer countries leads in this direction, since such technologies were usually developed to cope with conditions of expensive labor and cheap capital equipment.

Government policy can have profound implications for both the product mix and the production technologies used within industries. For example, policies which distort trade patterns may result in a "premature" shift of resources into industries that require more complex, capital-intensive production arrangements (Krueger et al., 1983). The size structure of industry in this case becomes more skewed towards large firms. Financial policies can have a similar impact. Controlled interest rates and credit rationing generally discriminate against small firms, promoting larger enterprises in every industry.

Government policy affects the evolution of firm-size distribution in the industrial sector in two main ways: by impeding the entry of new firms to the upper reaches of the size distribution and by creating a "growth trap" which helps to keep small firms with growth potential near the bottom of the distribution.

The combination of these influences yields the bimodal distribution of industrial employment by firm size, whose "missing middle" is the norm for low-income countries: many, possibly most, workers are employed in small enterprises, and, of the remainder, more are employed in large than in medium enterprises.

Significant gains in output and productivity can be made by creating a policy environment which permits (and preferably facilitates) both the growth of small firms into the middle size range and the creation of new medium-size firms. This is more likely to occur if governments avoid the indiscriminate promotion of small enterprises, and, instead, try to build up a sizable group of *progressive* small and medium enterprises ("firms with a strategy") that are competitive and innovative at home and abroad. For a number of reasons, such firms can help to spark higher rates of economic growth and foster a more equitable income distribution.

Economic Advantages of the Dynamic Middle.

Competitiveness. For a market economy to function properly, it must be competitive. Competition depends on the presence of many sellers and the absence of dominant large ones. These conditions are generally met in international markets because few countries export or import enough of a single commodity to determine market price. In domestic markets, however, a combination of trade protection and policies that limit market entry, promote excessive size, or encourage industrial concentration can severely reduce competition. Small and medium firms exhibit the competitive vigor necessary to preserve efficient markets.

Taiwan and South Korea furnish instructive contrasts to the Latin American situation. In Taiwan, the presence of many small and medium firms in the domestic market and only limited protection from foreign competition foster innovation and rapidly rising productivity. Firms that fail to reduce costs to competitive levels do not survive. New technologies and innovations in one industry or sector spread quickly to others. Korea, on the other hand, has more large firms and more state intervention, and thus also has less domestic competition than Taiwan. But Korea fosters competition in its industrial sector by exposing its firms to international competition and through policies that reward only those firms that perform. Together, Taiwan and Korea show that the firm size structure itself is not decisive for competitiveness and productivity growth.

Adjusting to economic shocks. When industrial firms become too large, the resilience of the economy declines. Small and medium firms render the always painful adaptation of the economy to changing circumstances a little more bearable. Large firms often resist cutting their operations, thereby prolonging the agony but not obviating the necessity of change. When domestic and international shocks hit, major changes in the pattern and scale of manufacturing production are called for; small average firm size facilitates the process of adjustment.

Flexibility to adapt to capricious international markets. Industrial growth and participation in international markets require progressive small and medium firms flexible enough to respond to the changes in prices, tastes and changes in technology that occur so frequently. This is true even in those developed countries which have had success in export markets in recent years, such as West Germany.

Employment and income distribution. It is often argued that, for any given level of investment, small enterprises create more employment than large enterprises. For this to offer policymakers opportunities to increase productive employment, small enterprises in important industries must not only be more labor-intensive than large enterprises but must also use resources as efficiently as the large firms. If they are labor-intensive but less efficient, special encouragement of small enterprise entails a trade-off between expansion of output and additional jobs. If, on the other hand, small and medium firms do not turn out to be clearly more labor-intensive, even the employment argument for preferential policies and programs disappears.

In any case, recent surveys of narrowly defined industries in India, Colombia, the Philippines and elsewhere suggest that the notion small manufacturing enterprises are relatively more efficient users of resources has no general validity, from either a technical or a social point of view (Little, Mazumdar, and Page, 1987; Cortes, Berry, and Ishaq, 1987). Medium-size enterprises, on the other hand, were found to be the most efficient in many industries.

In addition, these studies find extant differences in labor intensity among firm size classes *within* industries to be dwarfed by those *among* industries. This implies that a country's small enterprises will be labor-intensive to the extent that labor-intensive *industries* are prevalent in the country.

In essence, the studies show that short-term employment gains from the *indiscriminate* promotion of small and medium enterprises may be achieved at the expense of longer-run efficiency which would provide even greater potential employment benefits. Furthermore, expanding employment is not the only relevant policy goal: the conditions of employment are equally important. Creating more jobs in low-paid cottage industries or service activities indicates a lack of development, not its presence.

Policies and programs carefully designed to promote an industrial structure with a progressive "middle" of small and medium firms would, in our view, substantially allay the output-employment trade-off and produce rising real income. A policy environment which supports the entry and expansion of progressive smaller firms would be responsive to the fact that 20th century industrializers acquire technological competence by importing foreign technologies, adapting them to local conditions, and learning by doing as they move through the international product cycle. Expanding the number of firms engaged in the acquisition and diffusion of technology should contribute to minimizing any lags in this process, thereby avoiding slowed industrial growth and either stagnating or deteriorating conditions of employment (constant or falling value added per worker).

Entrepreneurship, learning-by-doing, and demonstration effects. Increased participation of small and medium firms will mean that more individuals can develop and utilize their entrepreneurial talents. In LDCs that now export trained and skilled workers, more of the available talent pool will find opportunities at home.

The existence of a large group of progressive small and medium firms can have a powerful demonstration effect for the rest of the economy. Innovations introduced by the most progressive firms spread in time to the less progressive. In addition, entrepreneurs learn from the success of others. The participation of progressive small and medium firms in economic growth can in this way produce benefits beyond their direct contribution to industrial production.

Policy Biases. The failure to realize the advantages thriving small and medium firms offer is partly attributable to policies protecting large firms from competition with the up-and-coming progressive small and medium firms and, in some cases, also protecting the small, thereby helping to keep them small and unprogressive.

The set of policies that protects large firms is well known and need only be referred to briefly here. Trade policy (tariffs and quantitative restrictions) is the worst offender. Other pervasive policy biases in favor of large firms include the structure of investment incentives, minimum-wage laws (which induce firms to substitute capital for labor) and overvalued exchange rates (which reduce the cost of capital below its social opportunity cost for firms able to obtain rationed foreign exchange or borrow in the international capital market). All these policies induce firms to become prematurely large and capital-intensive.

While large firms receive preferential access to credit, small ones may be frozen out of borrowing altogether or forced to borrow at much higher rates on "curb" markets. This makes it much harder for them to grow.

Some countries, notably India, have matched this kind of protection of large industry with protection of small firms, thus explicitly promoting a dualistic structure with a "missing middle." More commonly, however, policy promotes this outcome without intending to do so. A "small firm growth trap" is created by policies which impose, in effect, very high marginal tax rates on small firm growth. An example of this phenomenon was provided by EEPA work in the Philippines (Biggs et al., 1987). That country has a minimum-wage law, which most small firms evade, and sales and profits taxes, which they commonly do not pay. A small firm that pays profits tax, evades sales tax, and offers wages that are 20 percent below the minimum wage, faces a marginal tax rate of 85 percent if growth, and the official attention success attracts, forces it to start paying sales tax and comply with the minimum-wage regulations. If it cannot raise its profits by more than 85 percent, it will lose money by expanding. This example assumes that the firm already pays profits tax on its net income. If it was initially evading profits tax but had to pay a larger share of the tax as it grew, the effective marginal tax rate would be higher still. Besides the tax and minimum-wage regulations, there are other regulations which small firms can often ignore or "negotiate," but which become more effectively binding as the firm grows larger. Taking all these factors into account, the marginal tax on firm expansion can easily exceed 100 percent, providing an overwhelming incentive to remain "underground" and small.

Many small firms are established simply to provide their owners with a livelihood comparable to what might have been earned in wage employment. What we have termed "progressive" small and medium firms are different, since the owner/entrepreneur of such a firm typically hopes to expand over the long haul and has formulated a more or less coherent strategy for achieving this objective. The progressive entrepreneur places a high priority on technically efficient production and looks for ways to reduce unit costs and improve product quality. Most fundamentally, the progressive firm tries to anticipate changes in its environment and adapt to them, predicting and planning for change rather than waiting for changes to occur, then reacting defensively and possibly being left behind by the ongoing process of changing markets and technologies.

Progressive small and medium firms have already achieved a degree of managerial competence and are less likely to benefit from government assistance in this area than from policy and program interventions which enable them to overcome obstacles in the external environment. Such obstacles, and opportunities for overcoming them, must be identified on a country-by-country basis.[5]

The Role of Program Intervention. The above argument shows why we believe that policy measures must have a preeminent place in the effort to move towards an industrial structure in which dynamically efficient, progressive small and medium enterprises play a significant role. In the absence of an appropriate policy environment, government programs are likely to waste scarce resources and accomplish little. When the policies are right, however, several types of programs can be helpful.

First, becoming outward-oriented and thereby achieving a more rapid rate of economic growth requires a great deal of structural adjustment. Changes in prevailing price incentives cause industrial enterprises to alter their mix of products, upgrade their production process, explore new markets and invest in new capital equipment. The transition period in which these adjustments are made may be lengthy. Although price incentives and the workings of the market are the driving force behind an efficient adjustment process, appropriate institutions are needed, and these may not exist or function effectively. In such cases, selective government interventions may ease the adjustment process. Examples could include assistance in export marketing, finance (for modernization to meet the demands of the export market and for working capital), and access to specialized production services.

Second, the government has an important role to play in providing services which the market fails to provide or undersupplies. When not all the social returns to specific economic activities can be captured by firms or entrepreneurs, socially suboptimal amounts will be produced. Examples of incomplete capture include R&D

activities whose benefits can quickly and easily be used by competitors and employee training programs involving skills used by a number of firms. In such cases, the government can either subsidize firms to provide the needed services in larger quantities or provide the services directly through government programs. Access to information on export markets is a related example. The high cost of learning about such markets may deter firms from initiating exports, but once the fixed cost is incurred the added cost of diffusing the information to large numbers of firms is negligible. This is a case for program intervention.

Another way that markets may fail to carry out society's will is in achieving an equitable distribution of economic benefits. Particular groups may feel passed over in the process of economic growth. The government may want to address this problem by helping these groups to participate more fully in the growth process or, if that is not possible for one reason or another, to redistribute a share of the gains from economic progress to the less fortunate. The risk here is that governments may sacrifice too much economic growth for greater equity. If the economic pie does not grow, in the end there is not much to redistribute to those in need. A way to avoid this trap is to focus on those programs which promote equitable growth. This is what our proposals seek to achieve.

The Political Economy of Policy Change

Altering existing patterns of industrial development frequently requires the introduction of new policies to provide incentives and institutions intended to shape the behavior of investors, firms and wage earners, and often entails "a trade-off between favored and less favored sectors. . . ." (Cheng, 1986, p. 3).

Achieving significant change in national development strategies is no easy task. Policymakers who decide the direction and scope of public activities in developing countries weigh the often urgent and well-articulated economic advice they receive from international agencies and their own technical corps against pressing concerns about political stability and bureaucratic compliance. Often the political impediments to reform weigh more heavily with decision makers than do the potential economic benefits.

Impediments to the introduction of new industrial policy packages were not always so difficult to overcome. In many countries in the 1930s and 1940s, and in a large number of others in the 1950s and 1960s, planners and policymakers assumed major roles in defining development goals, setting the agenda for industrialization, providing incentives for domestic and foreign investors, and creating the physical and financial infrastructure needed for rapid development. Often, these efforts to chart the course for industrialization met with considerable response, and growth rates in the manufacturing sector were strong for a decade or more (see Hirschman, 1968; 1986). Over the longer term, however, these policies often encouraged inefficient industries, discouraged savings and investment, and led to stifling bureaucratic controls. In recent years, a consensus has emerged among many development specialists that exchange rates, interest rates, trade structures, wage policies, and private sector/public sector relationships introduced in the past to encourage industrialization now need to be adjusted if rapid economic growth is to resume.

Advocates of reform now call on governments to take the same leadership role in introducing policy reforms that they took 20, 30, 40 or 50 years ago. Yet governments appear to be less able to assume this role now than in the past, despite often greatly improved information, analysis, and advice. Today, constraints on altering existing patterns of industrial development are usually defined by the opposition of key economic groups in a society, the need of government to accommodate interests whose support is essential to the maintenance of political stability, and the resistance of bureaucracies that have become accustomed to wielding extensive regulatory powers. Moreover, many influential people in developing countries (not least in Latin America) firmly favor state-led development and find calls for liberalization and deregulation much less attractive than the earlier emphasis on state-building (Lancaster, 1986, p. 10; Nelson, 1984, p. 788).

In many cases, past development policies have created interest groups which now fight for perpetuation of their favored positions (see Bates, 1981; Grindle, 1986; Bardhan, 1985). Equally significant is the creation of extensive bureaucratic agencies to promote development. In time, most develop clienteles, regulatory power, and patronage-dispensing claims that they are loathe to see diminished through reform. Such interest groups are often able to block reforms aimed at undoing the harmful consequences of the very policies which created the interest groups.

Conditions for Reform. Hard as it is to alter industrial policy when economic and bureaucratic beneficiaries of existing strategies have acquired power to resist change, there have been many cases of successful policy reform in developing countries. Although each case of policy reform is unique and country-specific explanations are important for illuminating the conditions surrounding each particular reform effort, there are some general conditions that appear to facilitate the introduction of significant policy changes. The conditions are characterized by distinct ways of managing political and bureaucratic constraints. Three merit brief mention here: regime change, authoritarian control, and political "engineering."

Regime Change—through a military coup, revolution or negotiated transition—is a powerful facilitator of policy change. A regime change introduces new "rules of the game" for political decision making and the representation of interests. New coalitions of interests acquire power and may diminish the influence of entrenched economic groups. New leaders are often accorded legitimacy or forbearance to change policies because leaders of the old regime have lost support and credibility. Space for reform is created because regime changes occur in a context of political and economic crisis; preexisting policies and the governments that pursued them are often held responsible for creating such crises (see Nelson, 1984).

During the early months of new regimes, technical advisors and international lending or donor agencies often have considerable scope for influencing decision makers who are searching for solutions to severe economic problems. Moreover, when the new regime is dominated by the military, considerable potential for repressing opposition can be called upon. Bureaucratic opposition to change is often overcome through key personnel changes and through the greater centralization of authority that frequently accompanies regime changes.

Some of the most notable instances of policy change in developing countries have resulted from regime changes. Examples include the military coup in Korea in 1961, which initiated rapid export-oriented industrialization (Cole and Lyman, 1971; Cheng, 1986); a military coup in Brazil in 1964, which increased the economy's international competitiveness; the imposition of highly repressive military regimes in Argentina, Chile and Uruguay in the 1970s, which permitted major experiments in trade liberalization; and the coup in Nigeria in 1983, which made it possible to introduce controls on government spending and resume sensitive negotiations with the IMF. An ongoing example is the Philippines, where a revolution culminating in 1985 brought a number of policy reform proposals to the fore. Nicaragua's revolution of 1979 also ushered in significant policy changes, as did the return to democratic rule in Argentina in 1983.

Although regime change creates opportunities for reform, it is not a predictable event on which to pin hopes for policy change. In the first place, many countries for which policy reforms are widely advocated are not highly susceptible to regime changes. Mexico, Venezuela, Kenya, and Egypt may be cases in point. Second, considerable experience in politically unstable countries indicates that regime change does not always result in the imposition of effective government or better policies (see DeCalo, 1976). Third, these significant political events can be accompanied by repression of political opposition and abuse of human and civil rights. For these and other reasons, waiting for regimes to change in order to introduce policy reforms is usually not an efficient strategy for bringing about changes in important policies for industrial development.

Authoritarian control has often been credited with great capacity to introduce—indeed, impose—significant policy changes in developing countries. Such governments are thought to be hierarchical, centralized, and characterized by considerable consensus about the "correct" strategy of development. In such regimes, technocratic elites often have extensive access to decision makers and share an intellectual affinity for strong, centralized governments that appear to be both effective and efficient in exerting control over the economy and society (see especially O'Donnell, 1973). In such cases, the power of the authoritarian state can be enlisted to repress or dominate entrenched political and bureaucratic interests opposed to policy reform. Bureaucracies often become less susceptible to clientistic claims because popular support is less critical to authoritarian regimes than it is to more democratic systems in which leaders can be voted out of office.

Empirical support for the frequently cited link between authoritarianism and radical departures in public policy is mixed, however. Examples from Latin America, India, Korea, Indonesia, and Guinea show that authoritarianism can lead to significant policy change, but many regimes have been described as weak authoritarian systems, incapable of exerting effective power over society or economy (see Callaghy, 1986; Migdal, 1987; Jackson and Rosberg, 1986; Lancaster, 1986; Haggard, 1985). Stronger authoritarian governments, such as those in Latin America, are prone to crises of legitimacy and are susceptible to revolution and other pressures for regime transition (see O'Donnell, 1979). These regimes rely on closed decision making and repression of opposition, both of which inhibit the capacity to acquire feedback on the impact of their policies. Thus, even when such governments appear efficient in introducing change, their success may be short-lived because of longer term problems of legitimacy and sustainability. Recent experiences in Argentina, the Philippines, Korea, Iran, and India indicate the political fragility of many apparently strong authoritarian regimes.

Political "engineering" is a broad term referring to situations in which a regime does not change and unjust coercion is not used, yet significant policy change is introduced. Such situations are characterized by the active leadership of policymakers, politicians, and reform advocates in creating a coalition of support for policy change and managing opposition to reform. Through such efforts, policymakers and reform advocates try to lessen societal and bureaucratic resistance. In many cases, political leadership has been effective in selecting strategies and tactics that mitigate conflict (see for example Ascher, 1984). Groups of reform advocates can also attempt to influence policymakers and political leaders through mobilization of concerned citizens, such as the efforts of the Institute for Liberty and Democracy in Peru. According to an advocate of this approach, "the route to reform lies in opening up the system of decision making to all" (de Soto, herein). The objective of this kind of political engineering is to convince decision makers of the political rationality of responding to public demand making and participation. In Taiwan, for example, political engineering through bargaining and persuasion lay behind a shift to export-oriented industrialization between 1958 and 1961 (see Cheng, 1986, p. 22).

Political engineering may not be a feasible way of introducing policy reform in all countries, but it is a more manipulable and attractive strategy than waiting for, or actively seeking, regime changes or imposing authoritarian rule. In their efforts to bring about change, reform advocates use bargaining, negotiation and sweeteners to soften the impact of new policies on beneficiaries of the status quo (see Nelson, 1984). They can also mobilize mass constituencies for change. In dealing with bureaucratic resistance, the use of strategies to alter existing incentive structures is important. For political engineering to be effective, however, knowledge about how decisions are made and implemented in developing countries is essential. The policy process reveals much about how entrenched political and bureaucratic interests wield power over policy choices and how they express their opposition to reform.

The Politics of Making and Implementing Policy. In developing countries decision making tends to be centered in the political executive. Often it occurs in the halls of bureaucratic entities, planning ministries, the executive mansion, or political party headquarters. This relatively closed decision-making process and elite-centered politics leaves wide scope for pressures to be exerted through informal and nonpublic channels. "Understandings" with the military about which changes in development policies or budgetary allocations will be tolerated, unspoken recognition of the disruptive capacities of organized groups or economic interests, the implicit power of foreign interests and private "deals" struck in informal encounters with political leaders often loom large in explaining the political rationale for policy choices.

Policymakers in developing countries often must be extremely sensitive to the popularity and acceptability of the decisions they make because basic consensus about the legitimacy of the regime in power or the appropriate nature of governmental authority is lacking (see Migdal, 1987). Policymaking often "becomes a balancing act rather than a search for optima; a process of conflict resolution in which social tranquillity and the maintenance of power is a basic concern rather than the maximization of the rate of growth or some such" (Killick, 1976, p. 176).

Because policymaking tends to be a closed, executive-centered activity, large portions of the population are excluded from influencing the making of laws, decrees and policies that have direct impact on their lives. However, the phase of policy implementation may offer opportunities to reach the bureaucrats charged with pursuing the policies and bring pressure to bear on them. Bending the rules, seeking exceptions to generalized prescriptions, proffering bribes for special consideration, working out a deal, having a friend in city hall—these are important aspects of political participation in developing countries, which become more significant the more closed the policymaking process is. Governments often acquiesce to this informal and unprogrammed allocation of public resources for good reasons. Such participation, although it results in considerable "slippage" between the stated policy and what actually happens, may help hold a tenuous regime together.

These characteristics of the policy process in many developing countries—closed decision-making processes, the importance of informal influences, sensitivity to regime vulnerability, and slippage in policy implementation—affect the capacity to introduce and sustain policy changes.

In the case of *exchange rate policy reform*, conflict is likely to be centered on a small group of officials who determine, usually in secret, what the policy is to be, as well as in the reaction of sectors of the population most affected by the impact of devaluation. Once policymakers have reached a consensus broad enough to allow them to make the decision, and the central bank has adopted the change, the major task of reform is accomplished, assuming societal reaction does not topple the regime that introduced the change. Bureaucratic opposition will not be a significant issue in this type of reform because, once agreed to, it requires little administrative activity. Thus, those contemplating exchange rate reforms are likely to be concerned principally about issues related to maintaining political stability and these concerns will be criteria for assessing the questions of whether, when and how such a policy change is made.

Introducing significant *reforms in trade policy*, particularly by altering tariff structures, will generate both political and bureaucratic opposition. Critical arenas for conflict are likely to be centered in the ministries and agencies responsible for determining the content of trade policy and regulations. Tariff structures in many developing countries favor highly specific types and scales of economic activity; public protest may be minimal because effective opposition is difficult to organize when reform has differential effects on specific interests. In contrast, individual enterprises or groups of firms may have much to gain by exerting influence informally within the decision-making and implementation processes, attempting to shape the specific regulations or rates which affect them.

Bureaucratic agencies and officials that implement existing trade regulations often have developed extensive discretionary power to issue licenses, grant exemptions, apply rules, set rates, and expedite or delay the movement of exports and imports and may be amassing considerable bureaucratic rents from their control of trade policy implementation. Administrative structures, bureaucratic compliance, and informal arrangements with societal interests have considerable capacity to stymie the reform initiative. Policy reform advocates should therefore anticipate an ongoing set of tasks to monitor bureaucratic performance and ensure that extensive slippage in implementation of the reform mitigates against violation of its intent.

Financial and fiscal reforms—interest rates, credit controls, the level and structure of taxation—have important impacts on industrial growth and critically affect broad sectors of the population. To the extent that those who benefit from existing policies are able to mobilize to oppose change, they will probably do so publicly and also through more informal efforts to influence decision makers. Bureaucratic opposition to changes that affect discretionary power to allocate credit or to apply tax regulations may also be strong. As in the case of trade policy reform, officials and agencies may well resist efforts to diminish their capacity to accumulate bureaucratic rents. Reform advocates must therefore be prepared to build consensus among decision-making elites that the reforms are essential for economic development and feasible within a particular political and administrative context, and to oversee a process of implementation in which considerable resistance and slippage is likely.

A much easier situation is encountered in efforts to introduce *investment incentives*. Generally, such incentives do not threaten the position of current beneficiaries of industrial development policies but merely add new groups to those receiving special attention from the government. Such policy changes may be embraced by political leaders concerned about ensuring that their regime has broader political support and to reward new coalition allies. Moreover, bureaucratic compliance is less an issue than with other types of policy changes because investment incentive schemes often provide new clientele for public agencies empowered to implement industrial development policies. A much more difficult situation is faced when reforms in investment incentives alter existing incentives as well as introducing measures to encourage new departures in investment and production. In these cases, beneficiaries of existing schemes will resist efforts to diminish their favored position.

Political and bureaucratic opposition to reform initiatives will of course differ from country to country, depending on the degree and type of opposition to government policies that are permitted, the extent to which interests are effectively organized, the bargains struck among conflicting interests, the distributional impact of changes, and the capacity to engineer outcomes that both permit significant reforms and contain conflict at levels that do not threaten the viability of the reform or the stability of the regime. It should be clear, however, that the conflicting nature of industrial policy reform means that "persuasion of government officials will not be sufficient to ensure the adoption and sustainability of reforms" (Lancaster, 1986, p. 21).

Conclusion

This essay has dealt only obliquely with what some development analysts and practitioners characterize as the "informal sector." We have treated the phenomena thus labeled as characteristics of underdevelopment which are exacerbated in many countries by ill-advised government policies. We have focused directly on what we see as the main issues.

The informal vs. formal division has labor-market and enterprise aspects. In less developed countries, most people work for low wages (in small or large enterprises) or are self-employed at low rates of return, while a few are paid much better wages by larger enterprises or the government. This dualism has long been observed and analyzed by economic theorists (Lewis, 1954; Fei and Ranis, 1964; Jorgenson, 1966). The cure for dualism is development. As the empirical economists have shown, dualism disappears as economies grow and generate sufficient demand for unskilled labor (Kuznets, 1965; 1966; Chenery and Syrquin, 1975; Chenery, 1979). In high-income countries, most people work for large enterprises, where their labor is sufficiently productive for them to be paid a substantial wage or salary.[6] Although many small enterprises survive in rich countries, most of them aim only at providing a livelihood for their proprietor and his/her family; many fail even to do this, going out of existence after a few years at best. A few, however, thrive and grow, providing not only productive employment but a vital element of flexibility, innovation, and competition to the economy.

While industrial policies which will have a big payoff in the long term are being formulated and pushed through resistant political structures, what should be done, in the interim, about the existing informal sector? One clear point is that "informal" economic activities need not be regulated unless they pose a clear threat to public safety or morality. Often they provide the poor with better income-earning opportunities than wage employment in unskilled jobs. There is no justification for suppressing them on vague grounds that they are not "modern." There is indeed economic potential in this sector, and more of it will be released if regulation is relaxed. We also support policies and programs to assist the informal sector, but here we have several caveats.

(1) As agents of economic development, very small enterprises are, to put it bluntly, of little interest. Few will grow; most represent the survival strategies of very poor people. Despite the currently popular rhetoric, efforts to assist them are more in the nature of livelihood assistance than of development policy. More significant development efforts are those which focus on achieving structural change and promoting the participation of progressive small and medium firms in that process.

(2) Policies impinge in major ways on the welfare of those who depend for their living on the "informal sector." The most important step that can be taken to assist these people is

to reduce policy discrimination against small and "informal" enterprises. Carried to its limit, this type of policy reform will eliminate dualism itself. The rationale for policy discrimination against the informal sector is weak and based on special class and bureaucratic interests.

(3) Programs to go further and actively assist informal economic activities face many obstacles, most fundamentally the high transaction cost involved in any activity forced to deal with numerous small-scale clients. The best programs are those which improve the workings of the market—for example, credit programs providing small sums of working capital on commercial principles modified to fit the circumstances of small producers (see, for example, Patten and Snodgrass, 1987).

Given all this, our proposal is merely the obvious one that governments in less developed countries concentrate on achieving economic development. Unfortunately, many developing countries committed themselves to other paths, which led them to significant industrial growth for a time but terminated at a dead end. They now face the problems of policy reform examined in the preceding section.

Development means structural change, but this cannot be forced; it must be achieved in ways that are consistent with efficiency. Small and medium firms have an important role to play, and it is worth ensuring that the policy environment permits them to play it. Moreover, the policy environment which supports the growth of progressive small and medium enterprises is desirable on other grounds, since it happens to be one which is also conducive to efficient industrial growth, structural transformation, and greater opportunity for all individuals.

John P. Powelson

Comment

Cliff Barton of A.I.D. was the first person to draw my attention to the fact that in many less developed countries there are many small businesses, say five people or fewer, and a number of larger ones, 100 or more, but not many in between. The reason according to Barton was that the ones with five or fewer are invisible so the policy vultures don't jump on them, and the ones with 100 or more can either buy their way out or have enough political influence so they can defend themselves. It was the area in between that was vulnerable; hence the "missing middle" referred to in this paper.

There is a long tradition for those who comment on papers to start off by telling what they have been doing and only at a somewhat subsequent stage get to the paper that they're supposed to comment on. I would like to honor this tradition mainly because—this is my rationalization anyway—it will tell you a little bit about where I'm coming from, and then I think my comments about the BGS paper will be a little better understood.

The crucial part of the story here is that in the year 1974, I decided that most of what I was doing and saying and teaching

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was simply wrong. I came to a sort of mid-life crisis, and I began to review what I had been doing and where I should go next. Well, I had been dividing my time among academics and advising and living in Washington and working for the IMF and the Inter-American Development Bank. I've even worked for A.I.D. on direct hire and on contract assignments and so on, and spent a lot of time sitting around tables like this, so I feel perfectly at home here today even though I've lived in the Wild West for 21 years now and had to buy a necktie to come back to Washington.

But after economic advising in Kenya for two years, which ended in 1974, and having written a large part of the Kenya National Plan, the five-year plan, including the chapters on macro-economics and fiscal and monetary policy, I came to the conclusion that really what I was doing was primarily enhancing the power of the elites in Kenya and in other places, and probably discriminating against the poor. I recall that at the end of my assignment I was asked to write a simplified version of the economic plan so that it could be translated into Swahili; it was supposed to be comprehensible to people in elementary school and parliament.

[Laughter.]

So I could see that really what I was doing was putting out a propaganda device, and this didn't seem to me to be my job as an economist.

After I returned, I decided that I wasn't going to go out on any assignments like that anymore. I wanted to find out what did cause economic development and why some nations were rich and some nations were poor, and I figured the answer probably lay in history, so I started to read very, very widely in history. I've been doing that for the last 13 years, trying to turn myself more into a historian than an economist. I started making little notes. Whenever I saw anything that seemed to relate to economic development, whether it was an economic variable or some other kind of variable, I wouldn't forget my economics but I would cast it aside for a moment and try to see if I could figure out what things were most related to economic development.

Well, I'm going to summarize. I'm still working on a book which is going to be called something like *The Hundred-Year View: A Theory of Economic Development.* I'd say it's about five years away, but I'd like to tell you some of the things that I'm coming to in here. The principal one is that economic development takes place with a weakening of the centralized power and a proliferation of interest groups that bargain with each other, negotiate, and work out the rules of the economy. They hold each other accountable for the use of their own resources. That is, each person in using one's own resources becomes accountable to a large number of other groups.

This kind of society creates impersonal predictability and trust. I was very much interested in Janet's paper and the degree to which trust was a part of that, because in my studies of Holland and the northern Italian city-states of the Middle Ages, it seems that a principal factor in economic development was that they were small and the families all knew and trusted each other. A principal element of economic development is the growth of impersonal trust; that is, the growth of institutions that make it possible for people to predict accurately the behavior or responses of other people to initiatives that you make, so that you can have some kind of feeling of reliability about how the society and the social structure is going to respond.

In other words, the northern Italian city-states and Holland could not, by themselves, grow into this wider structure; the wider structure had to come from England and France and other places in Europe that developed it beyond the confines of the small ethnic group. And this I think has something to say about what may happen with the wonder children of Asia: the NICs of Hong Kong, Singapore, South Korea, and Taiwan. It seems to me that they are based on many of the same principles as the northern Italian cities and Holland and can only go a certain degree because the wider growth of institutions has to come from elsewhere. I think this principle relates very much to the BGS paper and also to Mr. de Soto's paper. Economic development takes place with the growth and proliferation of large numbers of groups that negotiate with each other and accompanies a weakening of the central power.

Another principle that I think affects this work is that there is very little or nothing that any organized group can do to change the overall set of policies of a government. The World Bank isn't going to do it, the IMF isn't going to do it, structural adjustment won't work, nor will the Baker plan. I'm summarizing some of my predictions, which go back to Peter the Great and other people who have tried similar things. Peter the Great was very, very similar to the World Bank. He was operating within Russia alone instead of all over the world. The reforms of the Ottoman Empire in the 19th century were very much the same. They were centrally imposed.

When we think of the great power of the central governments, imagine a superpower, coming from the international institutions, imposed upon the central governments, which then impose the policies upon their people. Having worked for the IMF for eight years, I worked up a certain degree of loyalty to them; it has taken a long, long time for me to break it down. I still think that the policies of the IMF are good policies, but the problem is that they are taking away from the people concerned the right to develop them themselves over time. In short, the proper policies will last only if they come in the course of negotiation among these proliferating groups. There are proliferating groups in less developed countries, as Hernando de Soto has pointed out to us, but they must have the opportunity to work policies out for themselves. When the IMF and the World Bank instead work it out for them, and bribe them with their funds to employ good policies, they don't figure out how to come upon such policies themselves.

This is probably not a very welcome message to A.I.D., to be told that economic development, when it occurs, will occur as a result of millions of different actions taken by millions of different people, not for the reason of economic development but for different reasons peripheral to it. Nobody can control these. In short, they happen in certain places and not in other places, and my task as the economic historian, writing my book on the 100-year view, is try to identify the reasons why they happen some places rather than others.

Now let me turn to the paper. I liked it very much—in particular because unlike a great many economics papers, it has a political section. But nothing was said in the paper about politics until the very end, and I thought that was a mistake. I would have liked to have seen the political section dispersed throughout the paper.

The question is, who has a vested interest in each of the harmful policies? If you have an overvalued exchange rate, there is some group that has a vested interest in that. If you have low interest rates instead of high rates to reflect the scarcity of capital, there is some group that has a vested interest in that.

The BGS paper suggests a number of policies for encouraging flexible, progressive, small and medium firms. I would like to ask what government, what interest groups are going to promote flexible, progressive, small and medium firms? Most of the government people won't be able to control them, most are not in that kind of business. Why would anybody have any interest in doing this? Outward-oriented policies also are suggested. Who has an interest in them? Exporters do, of course, but how many exporters are in the government, or how many exporters have formed an interest group that is able to get this kind of policy in their favor?

The BGS paper also suggests that government supply services where the market has failed. But why did the market fail in the first place? It failed because of government policies. I know this is a broad generalization with many exceptions, but the government is primarily the agent that caused the market to fail.

By the way, I'm not a total admirer of the free market. I think the free market works very well, but only in those situations where there is weakened centralized power and a large number of interest groups that hold each other accountable for the use of resources. If there is not that, the market doesn't work very well. The market failed because the government supplied services; therefore, the BGS paper suggests, the government should supply more services. There is a vicious circle here. The same was so when there was too much outflow of resources from Mexico, which the banks had permitted because the government wanted it. The policy to correct this was to nationalize the banks. The very people that were responsible for the problem concentrated their power to make it happen again.

I have been very much taken by Hernando de Soto's works. I would like to comment on his remark this morning about getting property laws that will help to protect the private sector. He spoke of organizing the informal sector to oblige President Garcia to pass this law.

Well, I think of this as one of those very, very little things, which in the aggregate—millions of them—bring about economic development. I'll bet it wasn't taken up in the *New York Times*, I'll bet people in Washington didn't hear about it unless one happened to be on the Peru desk or happened to be a legal scholar.

Historically, if we want to promote economic development, we cannot do it from the outside. The best thing we can do is help the weaker groups get stronger and the stronger groups get weaker, to help the proliferation of groups so that they can negotiate with and work with each other. And this is what has led me strongly to endorse the kinds of things that Hernando de Soto is writing about.

Let me end with reference to two paragraphs in the BGS paper. First, with reference to the 1930s and 1940s.

> Impediments to the introduction of new industrial policy packages were not always so difficult to overcome. In many countries in the 1930s and 1940s, and in a large number of others in the 1950s and 1960s, planners and policymakers assumed major roles in defining development goals, setting the agenda for industrialization, providing a set of incentives for domestic and foreign investors, and creating the physical and financial infrastructure needed for rapid economic development.

These were the years in which import substitution, industrialization, and all of the other policies that have been otherwise criticized were forming. I recall Hernando de Soto saying that, you can have command development for a certain period of years, but ultimately it's going to fail. And I think that is precisely what has happened.

The next paragraph is just one sentence: "Reform advocates must therefore be prepared to build consensus among decision-making elites that the reforms are essential for economic development and feasible within a particular political and administrative context." This simply cannot be done. The decision-making elites will never achieve consensus on something that will take the power away from them.

Instead, smaller groups must negotiate, piece by piece, and piecemeal by piecemeal, for their own interests. It's going to take 100 years or more.

Discussion

MR. SNODGRASS: Let me respond to just a couple of the things that Jack said in his very stimulating comments. I think the whole question of what it takes to bring about policy reform is an extremely interesting and important one, and I don't think that section of this paper takes more than a baby step or two in this direction. While I'm very sympathetic with the positive side of Jack's comments, the interacting groups and the growing pluralism and so on, and less formally I've had some of the same thoughts, I wouldn't go all the way to his pessimism about the possibility of policy reform in a period any shorter than 100 years.

One of the things that we are doing in the EEPA project that I think is rather interesting is a comparison of South Korea and Taiwan, which people tend to lump together as two of the four tigers of East Asia, but which in our terms have actually taken very different approaches to rapid industrialization. One of my colleagues, in a presentation at another seminar, suggested that after further investigation the idea of Japan, Incorporated, needs to be modified but the idea of Korea, Incorporated, needs to be underlined. South Korea has a highly centralized, state-managed approach to industrial development that has worked for Korea; but its transferability is highly questionable, dependent as it is on the existence of a very strong, very nationalistic, practically incorruptible state which is not going to happen in most countries.

The Taiwan approach is very, very different; it's much more decentralized and permissive and more suggestive of being a model in our terms because of the much greater scope for participation of smaller enterprises that it has afforded.

Finally, I want to comment on a couple of specific points Jack raised. The point of the paragraph he mentioned is one I was thinking of making during the discussion about well-intended and ill-intended policy measures. The original intentions of the policymakers may not matter so much, in the sense that once undertaken, policies build their own constituencies. And I think what we were saying in the paragraph that he read was that primarily import-substituting industrialization was something that the societies could do, but once having done it, this built a constituency for continuation of the same kind of policy and made reform very difficult.

MR. SPILLER: I surely enjoyed both the paper and more the presentation of the discussant. He actually stole many of the things that I was going to say, so I will try to emphasize some of the other problems I have with the paper. I do feel that there is a flavor of someone who is giving policy recommendations in the paper, and all these recommendations have the bureaucratic flavor that "we know how to do it."

One of the problems that Mr. Powelson mentioned is how to find those potential dynamic firms. This is not a new problem; we in Latin America have been trying to do it, clearly with tremendous failure, for the last 50 years.

Take the case of Brazil. The paper quotes an article that claims that Brazil has been successful in finding those firms. Well, they may have been lucky in some cases, but take the case of computers where there is the famous Special Secretary of Information which is the Brazilian MITI counterpart. They decide who can produce what, whether you can produce a computer of this or that size. Well, if we look at the computer industry in Brazil, while it has been growing, it is not competitive in world markets and it may never achieve international standards, given the rate of change of technology.

So the idea that we—bureaucrats or economists—can tell anybody who are the dynamic firms is just out of the question. This is one example of the bureaucratic response to crises that I cannot agree with.

One final issue. Why were the 1930s different? I think in Latin America, the 1930s were different because the constituency for change was a different one. The ones that you were going to exploit and to tax were those with assets that cannot be taken away. Mostly they were in the agricultural sector. What do you do with the land in the short run? In the short run you keep producing; in the long run you depreciate it, and that is what happened. In the short run exports were taxed by taxing the specific assets, and that generated growth. I don't think that was development, though. A lot of inefficient industries were created that after a while became the main source of stagnation in the different countries.

The taxable sector then was one under very inelastic supply. On the other hand, there was a large constituency to benefit. That same constituency is the one that today is going to be hurt from liberalization. That is, then, the one source of the problem. Now we have workers and industrialists for whom most of their assets essentially will lose their value at the moment you liberalize. This tells us why you have to be a magician in figuring out which is going to be the dynamic sector that will promote that type of reform.

There were, though, instances of reform. And unfortunately, I think, the author seemed to suggest that has needed a military regime to do that. I don't believe that, although in Latin America we do have the unfortunate case that reforms were introduced in periods of military dictatorship.

For example, the case of Uruguay is interesting. When the military took over they did not start immediately a process of reform; they actually kept doing the same things as before until they were hit by the oil crisis. Actually, they may have made the situation even worse before the oil crisis by increasing restrictions to trade.

When the oil crisis hit Uruguay, they had a totally closed economy. Imports were principally for industrial use, and there was no way the military could respond to an oil shortage with closing the economy more. Instead they opened the economy. My impression is that if the military were replaced by any political body under those same crisis circumstances, they would have had to respond in a similar way. In the same vein, it may not be astonishing that inflation control programs succeed in Bolivia and do not succeed in Argentina or Brazil.

I share, then, with Powelson, the feeling that we can give recommendations, but there is a collective choice problem that has to be understood. Perhaps more effort is needed to understand how political decisions are taken from a collective choice perspective rather than providing general macroeconomic policies that may not be implementable.

MR. JENKINS: Our objective at this juncture is to focus on the ways and means by which the assistance of individual enterprise in developing countries might overcome the formal, informal, and underground divisions within their economies. Don and his coauthors have clearly said that they believe there are real dangers in providing assistance to something called the informal sector. I think they also acknowledge, at least implicitly, that there are real dangers in providing assistance to the state. So there are dangers on both sides.

Now, we have the critical quandary between a rock and a hard place. I think, Pablo, you have reiterated some of the difficulties involved. Hernando has begun the process of saying what one particular organization in Lima, Peru, is doing, the kinds of steps they're taking. I would like to hear from as many people as possible, particularly if you have any positive answers, what sorts of things A.I.D. or others should do if they want to assist in including the excluded in overcoming these barriers—formal, informal, underground.

MR. REINTSMA: I would like to address that in the context of how you bring about policy reform, since there seems to be something of a consensus in the room that policy is one of the clear areas where we may be able to have some impact on increasing the political empowerment of the informal sector.

Dr. Powelson seemed to believe that there really wasn't much we could do in terms of trying to leverage policy reform from the donor's point of view; I tend to agree with that, and I also don't think we're going to get very far in trying to buy policy reform, as we are sometimes trying to do.

Is there validity in the approach of trying to develop indigenous host-country policy analysis capability so that host-country individuals will have a better methodology, a better ability to assess the impact of policy, or would your view, Dr. Powelson, be simply that changes will come only when power groups favor change, and that policy analysis capabilities aren't really going to get us anywhere?

MR. POWELSON: I appreciate your putting it that way. My general feeling is that an attempt on the part of outsiders to create policy analysis capability is rather patronizing. I had this feeling confirmed earlier as Mr. de Soto was speaking and telling us that they really know in Latin America what they want to do; they're capable of managing their own policies.

In the book that we put out on *The Peasant Betrayed—Agriculture and Land Reform in the Third World*, one of our principal points is that peasants know the best policies. They're probably better at agriculture than the Ministry of Agriculture is, because agriculture is so localized.

So I would say no, don't try to create policy analysis capability.

MR. JENKINS; How about just engaging in it where it exists?

MR. POWELSON: Well, engaging it where it exists, Jerry suggests; that's probably better. Here am I, an economist, suggesting something that is totally political. But I would stick with it—strengthen the weak groups, whoever they are, and let them work out their policies. Promote pluralization, promote the proliferation of groups.

I don't think it's necessary to define the informal sector. There's quite a bit of criticism of the informal sector in the BGS paper because it couldn't be defined, after which they proposed promoting the medium-sized firms without saying whether they could be defined or not.

Where you see a group forming that can negotiate for its political power, push it, but don't push it visibly. If you push it visibly, it will be damned.

MR. SNODGRASS: I have some disagreement with what Jack just said, in a sense. Take the example of farmers. I completely agree that given farmers know better how to grow things on their land than any bureaucrat, but given farmers are never going to make national agricultural policy. Some policies might recognize that fact, that farmers should have some freedom to determine how much fertilizer they use on their crops, and other policies might not. So it seems to me that an effort to work in the direction of an agricultural policy that gave more latitude to farmers and gave broadly more recognition to environmental diversity could well be worthwhile.

MR. POWELSON: Let me quickly comment on that, having just written a book on land reform. Land reform is not the kind of reform we've been talking about in the informal sector, but why is land reform taking place all over the world? Land reform is taking place all over the world not because of fairness, not because governments have seen what is equitable, not because the small farmer has any political power. Land reform is taking place because of urbanization and the fact that businesses—the new political power in the Third World—are swinging around behind it because they want a more efficient agriculture. They realized that the old hacienda system in Latin America or wherever wasn't providing them with efficient agriculture and cheap foodstuffs for their workers. It is this combination of forces—the groups negotiating with each other, forming alliances with each other—that actually bring about reform.

MR. PANSINI: This is to ask some clarification of some points that you make in your paper. One is where you say that "In countries at low levels of per capita income, small or informal sector firms account for as much as three-quarters of industrial sector employment." My first question is, does this mean that industrial sector employment employs more than informal sector employment.

In another place you say that in terms of economic development, "very small enterprises are, to put it bluntly, only of secondary interest." Would you please explain what you mean by that?

MR. SNODGRASS: Yes. The first statement that you alluded to is simply intended to say that in poor countries within the industrial sector, a large proportion—in some cases three-quarters—of total employment within the industrial sector is in small enterprises or what you might call informal sector enterprises. The other statement that you quoted is a blunt statement of our theme that what is really important here is structural change, that it has to occur. And related to that is the warning about targeting on the small-scale sector, on the small-scale people because of the potential inhibition to structural change.

And in passing I want to say we don't believe in targeting on any size class, including medium. That certainly wasn't the intention. What we would favor are policies which permit those few smaller firms that are going to move ahead to do so, but not a targeted policy.

MR. RUHM: I have a couple questions on this issue of labor reallocation versus enterprise growth. First, I think the distinction between the two concepts is unclear. You say labor reallocates to high-paying large firms. That would, I think, imply enterprise growth, so I think that distinction isn't completely clear.

The second point is that it is quite difficult to find data that will allow us to distinguish between labor reallocation and enterprise growth. I know for the United States it's only in the last couple of years that we've really been able to track enterprises and see whether they are growing or shrinking. So I don't know that I'd have a lot of confidence for countries with less data.

But the most important point I would make is that, assuming that the labor reallocation component is more important or at least as important as enterprise growth, it seems as if most of the policies talked about here are enterprise growth policies, and you say very little about the labor reallocation policies. We could be thinking of a whole group of things here: wage policies, policies to subsidize labor mobility, etc.; and these aren't even mentioned in the paper. So I think that's a fairly severe shortcoming.

MR. SNODGRASS: You're right, there's very little information for low-income countries on this sort of thing. One of the principal pieces of research that we were relying on was a British study which is not cited by name in the version you have, which is by David Storey et al., a 1987 book called *The Performance of Small Firms*, which reports on a 10-year panel study. And some of the principal findings there are that small firms are very important for economic growth including employment growth, but that a very small minority of the firms provide most of the new jobs. Out of 100 small manufacturing firms in Storey et al.'s British panel, only 40 survived for 10 years and half the jobs they created were produced by the most successful four. This is the sort of thing we have in mind.

So when we say that effect is going to be small relative to the labor reallocation effect, what we're saying is we believe that if you took a given population of small enterprises at a point in time and then came back and looked at it 10 or 20 years later, you would find that most of them had died out or remained the same, and that very few had grown. And of course, if employment increases, some enterprise is growing but that's further up the scale, is what we were trying to say.

MR. YOUNG: I trust that the 100-years framework that was thrown out was a bit in the extreme and just for rhetorical purposes, because you probably know the history—

MR. POWELSON: No, it wasn't. But go ahead.

MR. YOUNG: If it wasn't, then I can remind you and others that South Korea was considered a basket case in the 1950s, and people didn't know quite what to do with it, and now we're having trouble keeping up with them. So hard work, optimism, a commitment to broad-based development, and the right economic and policy environment may contribute substantially to a lessening of that time horizon.

Another question I have was with the position that you took. I believe you were saying that it's impossible to get reform from the elite. Yet, we don't have to think too long to realize that elites are not homogeneous; there are sometimes very substantial gaps among the elite. And external advisors can help to widen those gaps. The political scientists tell us that the reforms that do take place—and we do see reforms taking place—usually result from discussions among the elite, sometimes including the middle class in these discussions, not often including the farmers.

So I think there is a very important role to be played by long-term advisors in a policy dialogue bringing together people from the public and private sectors, from the developed countries and the developing countries, including what the United Nations system calls TCDC, technical cooperation among the developing countries. Sometimes less industrialized countries listen more carefully to the success stories from other developing countries than they do when it's the OECD countries advising them. It was mentioned that in some countries they listen more carefully to Brazilian advisors than to those from the United States.

There are some very important roles that aid agencies can play, and I've mentioned that one of them would be as advisors. Another role would be education and training, bringing people here or taking experts from here or from other Third World countries to the host country we're dealing with and involving them in a short-term or long-term, on-the-job or formal training of various kinds, to see how things work in other places. So education and training is another option.

A third one would be the kind of thing that Hernando is doing; that is, a very broad-based political dialogue and education and training program. The United Nations also tries to do this. When ILO had its team in the Philippines back in 1974, they didn't just hand a report to the Minister of Labor, they passed out 10,000 copies of that report and it's still referred to. I refer to it not because they've adopted all those recommendations. You were in Kenya, and you know the ILO report in Kenya wasn't adopted by any means in wholesale form. But they are still very important reference points in terms of what can be done, what kinds of improved policies are possible.

So those are just some of the options. I don't think we want to sit back and simply give up on the policy dialogue and reform process, and let historic economic trends slowly work their way up (or down!).

MR. POWELSON: I agree with you more than you know, and your comments are the kinds of comments that I frequently get. Somehow I put myself across as if I believe that we should really just sit back and wait for things to happen, and that isn't what I believe. Now, I do believe that reforms can come from decision-making elites, but I want to point out that the sentence here that I quoted was, "Reform advocates must therefore be prepared to build consensus among decision-making elites." That's not what I think is going to happen. Consensus among the elites to implement reforms which are not to their interest is unlikely. But it *is* possible to split off decision-making elites one against the other, and poorer people can, in fact, leverage their power.

If I may go back to history again, in the 13th century the town bourgeoisie in Flanders found that if they worked sometimes with the Count of Flanders and sometimes with the town patricians they could put their cases across. And if they couldn't work with the town patricians they would switch over to the Count. You see this over and over again in European history. Even peasants in the manorial courts of Europe in the 11th century switched their allegiance among lords of the manor, among various people of different categories, and sometimes they even had access to the king against the lords of the manor. And sometimes the peasants would sue the lords in the manorial court and win their case. Not very frequently, but once in a while it happened. It is this kind of shifting alliance among groups and leverage through the shifting alliances that will bring up the power of the poor.

I spoke earlier about proliferation of groups and negotiating among them, but I didn't have the time to develop it; I'm taking the time now in answer to your question. There are numerous techniques by which this is done. And I am trying to study them historically to make up general principles based on historical examples, to see if and how they can be applied under present circumstances. I don't have any hard results yet.

MR. WALLACK: I have three brief comments, the first two directed to Don Snodgrass et al., and the last one a suggestion for Jerry Jenkins' question.

For Don, in your section on conditions for reform, although you cite the problems of authoritarianism and regime change and political engineering, basically it seems, reading between the lines, that there is some kind of endorsement that in the short term, those might be useful techniques. I think that is, in a political sense, a little bit patronizing because it assumes that people in the developing world can't make decision making, as Mr. Powelson said, by consensus in a relatively participatory and democratic fashion. It may not have all the trappings of our democracy, but I think Hernando de Soto's work shows that in effect that happens.

And so I have problems with that, and would close this comment by saying that how can we as Americans recommend, even conceive of recommending that route when we ourselves would not accept it? At least I would not.

The second issue is about competition and structural heterogeneity. You say at one point in the paper that policy lessons suggest that you have to eliminate structural heterogeneity. But then you say that a system needs competition and that competition is based on small firms. I would argue that competition is not only limited to size but to number and frequency of participants and their participation. And I'm wondering if there's an internal inconsistency there.

The third issue is Jerry's question about what could we do, and one of the things I think we have to do is know our own limitations. I think most of us in our job performances are judged on how big a portfolio and how many projects we administer, and at the end of our fiscal years if we've got money left over we scramble to spend it. I think we're doing a disservice both to ourselves as well as to the people we are supposedly trying to help. And I think maybe the point comes when we have to say well, that money is left over, and I may use it but I'd rather not spend it if I don't know how. And I don't know, that may be putting us all out of a job but I'll run that risk.

MS. JOHNSON: Three points. One, I think we can share a sense of discovery this day that we are putting our finger on an element of development that we might label the necessity for an informal political sector. This accompanies the informal economic sector.

We can examine just what that is when we go back to our shops and so on, but it's quite apparent from the various comments, from the papers, from the respondents, that this interchange between powers that be and powers outside the power structure is quite important to establishing policy and administrative changes that stick. So let's have some fun and say, Ah hah! today we discovered and duly recognized the informal political structure as a part of development that we want to be dealing with hereafter.

Secondly, it might be news to us, but the PVOs for the last year and a half, two years, who have been recommending to Congress some changes that should be put in the bill, have not only suggested that a certain amount of funds, such as $50 million, should be put aside for loans to very, very small persons. They also saw to it that a section of at least one of the proposed bills includes a provision that the development agencies and the missions overseas will give due attention to establishing ways and means to build consensus and to promote communication between persons at the village level, the power structure and the policymakers. The words are a little different but there is this definite, specific call for building consensus and communication mechanisms within developing countries. Those PVOs don't come over and talk to A.I.D. because we operate under too many burdens of U.S. policy interests, but they do talk to the Hill and they do expect that the Hill will be leaning on us to give more attention to that in the future.

The third point is that I inquired around among private development agencies and did find one that had the imagination to put together a concept as to how to build a consensus. In essence it's a project proposal which entails a public policy association at the national level that will deal with analysis and policy prescription. But the association would also have an action arm for enterprise development and an action arm for communication with village-level people who are in agribusiness. If someone is interested in seeing one suggested approach, one concept paper, I'd be glad to share it.

MR. BIRDZELL: I want to make a couple of points. I wanted first to pick up on the sentence in the BGS paper where it says, "In high-income countries, most people work for large enterprises where their labor is sufficiently productive for them to be paid a substantial wage or salary." In the United States, the last time I looked at the numbers, about a quarter of the work force was employed in manufacturing industry, and of the work force in manufacturing industry, the 200 largest industrials employed about 31 percent; they produced about half the value added with 31 percent of the work force. Of course, that capital-intensive bias is due to the fact that statistically you measure the 200 largest by their assets, so you automatically pick the capital-intensive firms that are relatively not labor intensive.

But if you look across the economy, what you find again and again is that there is actually an efficiency bias against large firms as organizers of labor. Hierarchy has costs, and to the extent that you can avoid using hierarchical forms of management, there's a fairly strong motive for doing so. What you end up with is an economy in which labor is normally organized at the smaller end of the firm size spectrum, and capital, by default, tends to be organized toward larger firms.

The fellow who did the statistical work on this proposition, in spades, was the late Jack Glover who was at the Harvard Business School. He wrote a book called *The Revolutionary Corporations.* I don't know whether it's still in print, but he went into this in some detail. What you get, as I say, is this bias of large firms toward capital-intensive operations and small firms toward labor-intensive operations.

Now, this vision that is reflected in this sentence that advanced economies are economies of giant firms, super-efficient, huge corporations, is a very common illusion that applies, I know, to some of the people in large corporations. It applied with ruinous effect in 1927 when Stalin's first five-year plans were made up. The five-year plan was originally drawn as an extension of the New Economic Policy with emphasis on doing things on small scale, expanding small-scale economic activity in Russia. Then Stalin and some of his associates got a look at it and said, Oh, no, that isn't the way the Americans do things; we must do everything on a very large scale. And the Russians focused on developing very large firms which they never got away from and that has been enormously costly to them.

Now coming back to how this fits in with the role of large numbers of relatively small minifirms in developing countries, there is a fair possibility that the future line of development, the line of economic development in LDCs, will come more from an unregulated competitive sector, if you will—firms that now look small and poor—than it will from a protected sector that is held together by the assistance of the political authorities. You probably cannot achieve major economic growth without participating in the international trading economy.

The whole history of Western economic growth is the history of growth alongside increase in trade, and in international trade. One of the things that the LDCs which have these protected sectors probably have to do is develop an export sector that is not protected and is competitive. And they are, at a guess, likely to add more to their GNP by the operations of this kind of unprotected international trading sector than by the operations of a protected-plan sector in which they now have close participation of the government authorities.

One other observation on whether an advanced economy is an economy necessarily of giant firms. There is no reason why an LDC shouldn't regard itself as an advanced economy when it achieves something like the performance of New Zealand, Australia, Canada, or even Switzerland, which of course is lightly industrialized.

The questions of how you visualize an advanced economy, how you visualize size distribution of firms, and how you get there seems to me worth picking up, because as I say, if you have the idea that what you have to do to get an advanced economy is build a bunch of giant operations, giant enterprises, you'll never get there.

MS. TRUITT: I'd like to raise what I think is an assumption that we're making here that I'm not at all sure is accurate. We've been talking this afternoon about the importance of strengthening the poor, the informal sector, whatever we call this amorphous, difficult-to-define group. And it seems to me that we've been assuming that somehow they will act politically in a different way from the traditional way, certainly in Latin America—I'm not that familiar with Asia and Africa. In Latin America the tradition is to act as a special interest group to get some sort of special legislation which serves your particular group and which is precisely the kind of legislation we've been talking about all day long as harmful; harmful to economic growth and development.

Now, if we talk about strengthening the informals, it seems to me that we have got to look at our assumption as to how they are going to act. I'm wondering what is to prevent, for example, housing associations in Lima or groups of transporters in Colombia or whomever from simply using their newfound organized strength to make a special deal for their particular group with the powers that be. They are stronger but we have done nothing, it seems to me, to change the basic political structure or to help the economy if we continue to believe, as we have stated today, that the basic structure of the economy needs to be changed.

So it seems to me that we need to examine assumptions about how the political process takes place, and I suspect that is what Hernando was referring to this morning when he talked not only about the importance of simplification, decentralization, and deregulation, but about the importance of changing the way in which rules are made, because without changing the way in which rules are made, I don't think we'll see the kind of change from strengthening the poor that we've been talking about.

MR. POWELSON: I think that's a terrific question; that's one of the most important things that's been brought up today. I told Jerry I'd like to address this question, and that's different from answering it.

It seems to me that you are raising something that's beyond the control of outsiders. That is, the change in the rules is something that happens down the road, and *they* do it. And when I say outsiders I mean, of course, also the intellectual elites from the less developed countries who sincerely have the interests of the poor at heart but may also be of a different culture from the poor within the same country.

I suspect that simply helping the groups that we want to help, the weak groups, simply helping them strengthen themselves is all that an intellectual elite or an outsider, say from the United States, can do. And if, then, they use the system as it exists with special interest legislation, that's just the way it is.

I suspect that the idea of special interest legislation—this is the 100-year view—will change over time only when the special interest legislations offset each other, affecting many different groups, which begin to have commonalities. Then it becomes possible to have legislation affecting a large number of groups.

As I talked with Mr. Birdzell during the intermission, he was explaining why contracts are enforced, particularly where the law courts are not strong enough to enforce them. They will be enforced because it is to the interest of both sides to enforce them. Carrying the same general spirit into a different connection, you may find a lot of special interest legislation that overlaps, affects many different interest groups, and then tends to become general legislation.

Look at the legislation during the 1930s in the United States that protected security investors. This affected a large number of groups. They could have been many special interest groups, all looking for legislation that really affected them, but in order to get it passed, they had to combine with other groups. That's the way it has worked in the West, that's the way it has worked in the United States, and I have a feeling that it's the way it is going to work in the Third World.

MR. PANSINI: Some of the A.I.D. research seems to indicate that there is a certain level below which credit should not be given. That's an especial concern to us in the Women-in-Development Office because it's at that level that countless women are involved in business. In spite of A.I.D.'s theory, A.I.D. has in fact assisted those kind of people through organizations like ACCION/AITEC, FINCA and others. Moreover, there is evidence that some of the models being developed by programs like the Grameen Bank, Women's Working Forum and numerous others should be looked to for ideas on how A.I.D. might better impact on that level of entrepreneur, especially as far as a WID office is concerned, for it is at that level that most women work as entrepreneurs and where a favorable impact is possible.

MR. REINTSMA: Without putting Mr. de Soto on the spot, I wonder if he has any particular insights or answers to the question you posed about what agencies like A.I.D. can do to address the issue of what needs to be done? Other than, of course, the obvious one of funding institutes like his own.

[Laughter.]

MR. de SOTO: Well I'm glad you said it. Somebody from A.I.D. asked me that question, as a matter of fact, and I really couldn't answer it because I haven't put myself exactly in that situation. I just told that person about our experience in ILD that might serve as the basis to answering your question at a second stage.

The first time we came for this kind of work to A.I.D. was in 1984 when the type of publications we were doing in Peruvian magazines was about what the informal sector was, when we were revealing for the first time to Peruvians that six out of every 10 of us had nothing to do with the state, or that the government is only governing 40 percent of Peruvians, if you want to try and look at it figuratively.

This sent sort of a shock wave through Peruvian public opinion that has really not abandoned us all this time, and the person who caught on to all of this was the president of the Republic, Belaunde, at the time. And Belaunde called me in and said, you know, this has caught on; there's no doubt that this is going to be like the wave of the future because we've identified a force of renewal and one that's destroying our actual wave beam so we're going to have to change eventually. So I'm a politician, I want to react to events and to forces that are in movement; what do you recommend I do?

And I said, well, you've got about a year and four months left. I don't think there's too much that you can do in a year and four months in terms of grassroots work. But you could do something very relevant if, for example, you started what we call democratizing rule making, or the literal translation in Spanish is democratizing the production of law. And he said that makes a lot of sense.

Then secondly we talked a little bit about property titles, things that put people closer to their possessions and legitimize what they were doing informally. And he said, good, let's do this kind of thing. How do you suggest we go about it? So I said, well, it's going to take experts from abroad because rule making is something that Americans and Europeans do all the time; they just don't know that it relates to development very narrowly. So it's a question of bringing them over and seeing what different systems exist and comparing it to our own notes on the informal sector where rule making also takes place but at a more local level. And let's make our cultural way of looking at these things compatible with modern techniques for doing this. He said, great. What do you suggest as the next step?

I said, finance us. He said he didn't have the money; where could we get it? I said, I saw pictures of you with Peter McPherson the other day reviewing one of your favorite projects, Pichu's—something like that—why don't you send him a Telex. And he said, good, I'll write one. And he wrote him a Telex, and I took a plane a week afterwards, saw Peter McPherson and we got that funding.

Now, we worked on it for a few months with Dr. Bustamante who is here, and we took different people who had worked in rule-making activities in the United States and we actually got a law through. I think it took us nine months and we actually produced a law.

But we explained to him that the condition for this system to work—sorry I'm rambling on but I'm recollecting as I'm telling you—we explained that for this to work it was very important that whoever sat on the apparatus we created—which had practically no bureaucracy just one or two people—but whoever sat behind the rule making must insist that no executive branch authority be able to bring out a law that affected the private sector without a cost-benefit analysis of some sort and without opening it to comment and notices, or having the possibility of calling hearings on it. No law could come out without complying with those requirements. There were a few exceptions, those that dealt with foreign affairs, those that were for emergencies and laws affecting these areas would have to be justified later on—quite similar, again, to your system.

We said that what we had been able to gain from a study from history was that this would hold together provided the president came down very hard on whomever violated this. So we suggested that whoever presided over this agency which we called the Commission on Economic Rights should have at least a ministerial rank, and the president—since what we were going to do was get a more and more publicized vested interest for leaning more and more on the president—said, look, I can't do that, I can't create another ministry now. That would look bad if I'm trying to work against an overloaded system by creating another post. Anyhow, we got that through by him putting one of his preferred political people to head it. But we said, you've got to come down on whomever violates it. When the law came through I think it was for about two weeks that we survived. The law started producing cost-benefit analyses, hearings were organized, we held seminars with the ILD. At one of the seminars I think 80 of the highest government officers came to our training courses. It started working.

And then one minister dared to pass an executive decree or something of the kind with a lot of significance in industry—the Minister of Industry I think it was—without complying with the requirements. So we went to see the president and said, hit him. Knock him. As a matter of fact, we were helping the president because we got editorials in practically every newspaper from the left to the right saying, hit the son-of-a-bitch, you know, give it to him really hard. And the president didn't. And the system sort of fell apart. It didn't sort of fall apart, it just fell apart.

The same thing occurred with all the other things we were looking at. We were very downtrodden. I remember we sort of regrouped and said what do we do, because we still have some of these funds left. So we went to see the A.I.D. Director in Peru and we told him this is what we're going to do. He said, no, I'm not going to get involved in anything you do; go ahead and do it. So what we did is we put an ad in the newspapers—I think it was called "A Necessary Settling of Accounts" or "Let's Put the House in Order"—and we told the president, thank you for the trust and everything, that we were passing over to the opposition. And we then formed an ombudsman system that actually went into opposition against the government and then we started pressing the government for changes on very specific issues like land titling, like property rights, like contracts. And what we would do for that is what I explained before, we would collect signatures and use editorials in the newspaper and press for change and mobilize public opinion in the public sector. So far there isn't one draft law that we've prepared at the Institute which hasn't either been passed by government, central government, by local government, or hasn't as a matter of fact gone into parliament and is under consideration in the committee.

But the condition for that was to have our hands free to attack and debate. In other words, we go back to it every time we've had an offer from a municipality or a government body or even central government, such as the case I've mentioned with the council in Lima. Where we've tried to do something, vested interests have tied us down whenever we have been within government. And we haven't, of course, been able to shoot at our ally. It's when we've gone away from the ally—we've been, for example, more successful with Garcia than we were with Belaunde. With Garcia we've gotten practically everything through because we bother him and we use the democratic system all the way to the last consequences.

When we don't use the democratic system, when we don't do some of the things that Mr. Powelson was talking about, empowering the poor, really putting people in a position so that they threaten vested interests with a worse consequence than the one of not approving the law, we don't get places.

Now, what that means for A.I.D. I don't know. We were saying before, you couldn't act directly; maybe what you should do is find a way of doing what the German foundations do—I'm speculating now because I haven't thought this through but I suppose that's what you wanted me to do. If I think of the German foundations like Konrad Adenauer Foundation or all these foundations that are basically government-funded and that take political positions in developing countries, they go out and threaten even the host government. But then, of course, the German government just shrugs its shoulders and says that has nothing to do with us really, it's just the old foundations that are doing it. Use the democratic system.

That, of course, as you will see, also means that you can keep on funding us; it doesn't oppose it.

MS. LANDA: I have two questions for Mr. de Soto. Your paper emphasizes the importance of extralegal norms created by the informals. I would like you to describe some of the mechanisms by which the entrepreneurs in the informal sector enforce contracts. This is my first question. My second question is as follows: in your paper you said that the informals have little choice but to associate themselves almost tribally when pooling capital. This statement seems to contradict an earlier statement where you said that the market economy created by the informals is nondiscriminatory.

MR. de SOTO: Regarding your first question, Ms. Landa, the way extralegal norms are created in the three sectors we describe—

transport, housing, and industry or commerce—is that in all these associations whether they're street vendors or industrial organizations, there is always democratic assembly that takes place, that is elected. And it's this assembly that, as the problems surface, decides how they're going to tackle them. And as they do, they start producing rules, and a lot of these rules are now written down.

They say, for example, that there is a problem of sewage; they can't get the government to finance a sewage disposal system or even a road—there's a lot of private road building in young towns—and that they're going to have to do it themselves. Then they decide how people are going to be taxed or how they provide work so they can contribute in kind.

Or again, when there's a security problem, they have to take turns policing, for example. Or they decide how they're going to distribute joint profits from some joint activity. For example, when the bus drivers set up a gas station and the gas station actually starts providing services to other vehicles that aren't part of the committee that operates the trucks or buses, they must arrange to divide that up. Or if they've got a savings cooperative, on the basis of what rates are they going to make loans, and how do they punish people that do not reimburse whatever they owe. All of these things they decide together, and after a while it's generally written down.

The way they actually do these things is very common, one to the other, because they inspire themselves by drawing on other people's successful experience. So in the end, all of these extralegal norms have certain common principles. Most of these common rules are the result of atomized bodies of poor people doing specific things, which build community life and become articles of association and rules that form a common law of the informal sector. This informal common law then combines with those aspects of Peruvian formal law that they find applicable. And that's why we call it extralegal norms and not just the common law. It's a combination of those things of Peruvian law that make sense and those things that they have created themselves to substitute for those laws that do not make sense within the legal system.

In terms of tribal behavior and exclusion, what was meant by that was that instead of being able to use business organizations to associate themselves in the informal sector, as when somebody wants to set up a small factory and he needs not only his capital but somebody else's capital or somebody else's resources in one form or another, he can't say, look, I've got a limited liability corporation that's just put out 100 shares, and I'm going to take 40 and I want you to take 30 and you to take 20. He can't do that because there's no shares to distribute, he doesn't have a legally formed corporation. We found out it takes 289 days, for example, if you want to register a business.

Let me give you the example of somebody, say, with a button factory. Let's say I've got a machine to manufacture buttons. It's not a buttons factory, it's a buttons workshop. But to be able to sell the buttons I need more than a machine; I need the help of somebody who knows how to sell these buttons and knows who the potential clients are. And it might be that the best button seller in town is Jose Suarez who, as a matter of fact, lives just down the street.

So I'll tell Jose Suarez, "Look, I'll manufacture the best buttons in town, and you do the selling," and that's a very good combination. So if I were legally incorporated I would say, "Well look, I figure that the resources required to manufacture buttons are really 70 percent of the total resources, and the ones that are required to sell buttons are 30 percent, so let's get a joint venture, let's get a corporation together and you'll get 30 percent of the shares."

Since I can't incorporate because it takes 289 days, Jose Suarez will not trust me. Jose knows that even if a manufacturer promises 30 percent of the proceeds, in place of 30 percent of the shares, once I know whom Jose is selling to—which I will eventually know, since we will be working together—I can just exclude Jose from the business a year later. There's probably only three or four major clients of the business.

So Jose Suarez won't work with me, even though we are the ideal combination of resources. As a result of which, I will have to take in as a salesman somebody who is closely related to me, who has that enormous trust that you had talked about among informals in Asia. In other words, it's a cousin whom I can put the pressure on through my mother, through my father, through my aunts, through my uncles, and whom I trust; but unfortunately not the best salesperson.

When I referred to associating tribally, I didn't mean that I was going to exclude other people from the button business. It meant that when I was pooling resources together I had to use those mechanisms of kinship that you talked about, which I considered rather tribal, compared to the possibility of actually being able to contract the best resources for my button business. He could be impersonal and needn't be somebody of kin as long as he is the right person. I could simply make a deal with him through contract, even if I didn't know him. We could split up the shares.

I was using tribal as opposed to modern contractual means to associate resources. I don't know if I have been clear.

MS. LANDA: If you have a group that acts tribally in your sense, others who do not belong to the same tribe will be excluded. I don't know how widespread is the problem.

MR. de SOTO: Imagine that we're in the bus business. Let's get away from buttons. Imagine that we're in the bus business and we have Route 73. On Route 73 there are 80 buses that service that route.

Let's say my bus costs $70,000; that's the price of a Dodge 300, for example, in Peru. It requires $70,000, and I've only got $40,000. I need $30,000 more to get the bus. Well, I'm going to have to associate tribally with a cousin of mine because who else is going to trust me for those $30,000. I've got no legal method with which to share the proceeds by giving him 30 percent of the shares and my keeping 70 percent.

Now, the fact that I have to do that with my bus doesn't mean that if we need a bus number 81 or bus number 82 or 83 to have higher frequency on the route that I'm going to block people from coming in. It just means that I have to associate tribally in terms of the shares, in terms of sharing property on a particular vehicle.

But it doesn't mean I'm going to exclude other people from servicing the route, provided the other bus drivers do what I do which is submit to the common rules, et cetera.

In other words, my tribal association was referring to the micro units of property, not to excluding somebody else from the trade per se. It's a way of sharing resources on a particular vehicle, shall we say, rather than excluding other people from coming in and servicing the routes.

MS. LANDA: Let me extend your example and look at marketing of goods across firms. If you need three trading partners, the same element of trust will lead you to choose three of your kinsmen instead of contracting impersonally with the indigenous population.

MR. de SOTO: That's right.

MS. LANDA: Those are the kinds of discriminatory forces at work that I am speaking about.

MR. de SOTO: Oh, yes, in that sense, absolutely true.

MR. JENKINS: You're talking about two different levels of analysis, though, Janet. Where Hernando is talking about a firm in the shadow economies, you're talking about a set of entrepreneurs, I mean several firms. At least that seems to me the way the discussion is going here. Also, just off of contract law for a moment to property rights and property law, isn't exclusion absolutely essential to individual property—

MS. LANDA: That's right, yes.

MR. JENKINS: So Hernando or anyone who believes in the establishment of property rights for investment and development of the individual is going to say, of course, there has to be exclusion to some degree; otherwise, the property rights are meaningless.

MS. LANDA: No, it's not that kind of exclusion that I'm talking about. I'm talking about trust. If you trust only certain kinds of people and not others, if you trade with certain people and not others based on race or ethnicity, this is discrimination. That is the kind of exclusion I'm talking about. I am not referring to the notion of property rights as the right to exclude other from its use. I'm talking about racial discrimination, discrimination and exclusion of others from economic activities on the basis of ethnic status. I don't know whether this form of discrimination is a problem in Latin American countries.

MR. de SOTO: I'm sorry, I think actually the best case made was just done now by Jerry. What I meant was—simply following the thing about exclusion—since the informals do not have a power of coercion, they cannot exclude anybody from coming into the trade. For example, the button business. I'm an informal, I'm in the button business, and I'm working with five cousins on my machine. I can't stop anybody from across the street putting up his button industry. If I'm in the formal sector and I have an insurance company, I can act through superintendents of banks to say there should be no more than 30 insurance companies in the country with which I have limited competition. I was saying that the informals cannot do that.

And then when I talked about tribal association, it just meant that because I've got a property rights problem at the level of the firm, I do use tribal means to associate since I don't have any of the business organization instruments or legal contractual instruments which allow me to bring people together.

So we're talking actually at two different levels. Probably I'm thinking in market terms and in firm terms, and you're thinking along other lines. I'm not too sure. But why don't we let Mr. Powelson comment, he might bring a light into this.

MR. POWELSON: Well, this is another aspect of the question. You've been raising the question of trust, and I'd like to think for a moment on how trust is created. And the answer, I believe, is that trust is not created by trusting, because trusting someone where trust is not deserved usually doesn't work and gets you to a point where you'll no longer trust trusting.

Rather, I think back on historical examples. For example, when the Europeans, let's say the Portuguese, were first appearing along the coast of Africa—this was long before they became exploiters and slave traders—they wanted to do business with the Africans. And here were Africans who spoke different languages, had different concepts of business, different tribal relationships, that wanted to do business with the Portuguese. How did they manage to trust each other?

Well, they tried it without specifically trusting each other. Don't put up a great deal of collateral, don't get into a very big business but do something once, and then if it works once, you do it again, and if it works again you do it again, and it gets a little bit bigger each time. And the two people very different from each other begin to be able to predict each other and recognize that what each one does is to the interest of the other, and if you violate the trust, you're gone and the other person is gone because there is a case of mutual benefit.

You begin to build up on that. We can see this historically. And after a while you begin to work out a contract. Then, having worked out a contract, you work out another contract. And then having worked out another contract, you begin to work out the rules of contract. Next you find some authority which may be a neighborhood authority or just a very local group that will enforce the rules of contract. This expands little by little by little, and through the formal system of contract law you get to the possibility where you can trust people who are not your immediate neighbors or not people whom you have done business with before.

I can go into a department store in downtown Washington, Woodward & Lothrop, let's say—I haven't done business with them for years—and I can immediately trust them because they fit within a framework that we all know. Well, you know this, but this it seems to me is the way trust comes about.

MS. SOOS: I'd like to address the notion of what the donors can do to help promote the integration of these economies over just promoting growth. We've looked at a few issues like helping the policy institutions and others, and I think we'll be lucky to find many as sophisticated as the ILD in other countries. We've talked about policy dialogue, maybe looking at some policy issues that get closer to the sectorial level because much of the donor policy dialogue has stayed at the very large macroeconomic level of not even interest rates but exchange rates and budget deficits and that kind of problem. There's been much less emphasis on sectoral issues, with the exception perhaps of marketing and some other discrete areas.

But I think we need also to look at the issue of what donors actually spend their money on that might be negative. In many cases, we have continued to build up government institutions and economic roles and production and marketing roles where perhaps we should not. And those can have a very negative effect on the competition. So we need to be very careful about that and put more of an effort on building up the economic pluralism that generates the dialogue and the pull and tug and the compromise, consensus-building of what laws and policies should be to promote growth from within the economy.

5 *Hernando de Soto*

The Informal Path to Transformation[1]

The paper by Tyler Biggs, Merilee Grindle, and Donald Snodgrass will be required reading at the Institute. I have little quarrel with the policy reforms which they recommend for Latin America. However, what I think is missing in their presentation is the relationship of the informal sector to the possibility of effecting policy reform. They acknowledge, of course, that their paper does not dwell too much on the informal sector because they don't really see how it relates to doing the essential thing, which is policy reform to further development.

But surely Biggs, Grindle, and Snodgrass (BGS) know that the policies they recommend have been advocated for many years in Latin America. The gospel truth has been known for 40 or 50 years, but the problem is in discovering by what means Latin Americans will come to understand that it *is* the gospel truth. To know that it is *not* understood, all you have to do is visit our universities, or visit the Economic Commission for Latin America or see what is being written in most of our newspapers or learned magazines. What you will find in those places is not what is contained in the BGS paper. So the central question is not what is the gospel truth, but how might people come to understand it.

I think the reasons why it is not understood are manifold. One of them, of course, is the cultural reason. Most Peruvians and Latin Americans generally, feel they are not capable of doing what others have done. That's why some of the work done in the informal sector on the financing and the encouragement of microenterprise has been very instructive; by showing that people can use even small amounts of credit, whether it's $50, $100 or $150, and be able to repay it breaks the cultural myth that Latin Americans cannot handle credit and don't know anything about enterprise. The demonstration effect of this is crucial. Otherwise, there is no refutation of the cultural myth, or of the corollary myth that we therefore need a very large, intricate state that goes into great details, planning and doing all the things "for" us which the paper by BGS says should not be done. Simply expressing the gospel truth is insufficient for gaining people's understanding. Demonstrations of the truth are required. Ironically, they are most amply provided in the informal sector which these authors term a "heuristic device."

Also, contrary to what is suggested by Biggs, Grindle, and Snodgrass, the informal sector is not composed of only small enterprises. In Peru, for example, the vehicles in Lima's informal organization are worth about $640 million, and can by nonoperation paralyze the city. So there are all sorts of informal enterprises; there are large ones, there are small ones; they are not necessarily small.

We have tried, in Peru, to define informality in terms of what can be called positive action. Peruvians have been admirers of neo-Marxism-Leninism, even though we have seen for a long time that it provides no formula for the creation of wealth: countries which follow these ideologies have turned out, in their respective categories, to be the poorest in the world.

But what has also been seen is that these ideologies have provided ideas which have been very useful in terms of taking power and having ideas prevail. I think the reason for this success is that class analysis is a good marketing system in political terms. It's a theoretical approach, generally speaking, that says that individuals and groups engage in positive political activity on behalf of their interest and values as they perceive them. If one can identify the interests that bring people together to do positive action, one is then able to get one's policies across, especially in democratic countries but even in Latin America and dictatorships where popular opinion is also very important.

So one of the things that ILD did was to identify the informal sector as a group of interests which are negatively affected by the (bad) institutions and policies of the state. Rather than an academic definition of the informal sector, we identified the informal sector as comprising all those people who suffer so much as a result of existing institutions that they have had to form their own institutions. The objective was to create a constituency for the change that the gospel truth requires.

One of the problems at this time is that there is no constituency for the kind of change proposed in the BGS paper. Aside from Argentina, where the El Sogori liberals have got maybe 14 percent of the vote in Buenos Aires, there is not one single party calling itself neoconservative that has received more than one percent of the vote in any part of Latin America. So until that is changed, until people perceive what you are saying in terms they understand as affecting their interests, there can be no mobilization possible for the kinds of policy changes advocated in the paper by Biggs, Grindle, and Snodgrass.

At ILD, we have essentially said what BGS say, but in language which the majority of the country can understand in terms of their life experiences. So when we say, for example, that it takes 207 steps over six years and eleven months to get real estate in Lima, people start understanding what property rights are all about. When we say that it takes 289 days of red tape before you can actually register an enterprise with two sewing machines, then people who are poor also understand what we're talking about. When we say that there's no way that you can get insurance or that you can get recognition of the property represented by your bus or truck, then people understand that rights may and should be associated with property. When we say that you have no contracts for long-term financing and you can't finance the purchasing of equipment long term, then poor people understand what we are talking about.

We have used a number of experiments for the purpose of determining that the understanding of ILD and the informals is shared. For example, we had a campaign on the need for giving property titles instead of direct financial assistance to people in the shanty towns of Lima. We took our draft law to the public and asked for signatures in its support. It received the support of over 500,000 people. And, when the book came out, over 300,000 signatures were provided in its support by all the informal transport organizations of Peru. When we talked about the freedom to rent and the necessity for allowing people to dispose of their property as freely as possible within an adequately regulated order, we received in one day over 176,000 manifestations of individual support.

In other words, we think we have identified what the Marxists would call a class of people grouped around their interests, and this group of people is defending all, or at least most, of the values espoused in the paper by Biggs, Grindle, and Snodgrass against those advanced by the extant mercantilist state.

We are not so concerned with the failure to devise an analytic definition of the informal sector as are the authors of the other two papers prepared for this seminar. If we were only concerned with analysis, we would probably share their discontent with the imprecision and variability of its definition(s). But just as we are more interested in understood "truth" than in some private "truth," so is ILD more interested in action with analysis, or with analysis having definite implications for positive action by those being analyzed, than in analysis whose implications might only be discussed in academic seminars and scholarly journals.

In fact, ILD did not begin its analyses with a word or definition. We began with clearly observable activities, and called the participants "informals" simply because it is a word that sounds all right in Peru, and is a label in terms of which individuals would identify themselves. We tried various words. We've tried the "Indian Entrepreneur Community," we've talked about "small entrepreneurs." It was impossible using "capitalism"; it's a very bad word in Latin America. I believe we should fight no crusades or lose any lives defending only words. The word that stuck was "informals." If we had used the word suggested in Janet Landa's paper, for example, the Shadow Economy, I don't know what the results would have been; only people who had seen a Darth Vader movie might have identified themselves.

It's "informal" that caught on. I don't doubt that there are better words and that there are better concepts academically, but this is the concept around which people have begun to think and people have begun to feel identity. In only six months, Peruvians have purchased *El Otro Sendero* in numbers that are approximately 20 times more than their combined purchases of the books of Milton Friedman and Kenneth Galbraith. The reason for this is obviously not because we're better than they, but simply that we've talked about all the problems of Peruvians in language and terms which mean something to the people whose support is crucial if you want to achieve structural change.

It is in this sense that I agree with the suggestion of Janet Landa's paper that we have not said much that is new; we've simply taken old, good ideas that have been tested throughout time in the West and adapted them into forms that are useful in a country like Peru.

In that connection, as all those who have read *El Otro Sendero* know, what we think we have in Latin America, and certainly in Peru, are incomplete markets and incomplete democracies. We believe that if our democracy really worked well, if we had all the institutions required for governments to get the feedback of what is actually going on, there would not be this enormous 60 percent of the economy that is working underground. Instead, the democratic institutions would have allowed governments to satisfy their constituents adequately, and there would have been no need for Egyptologists like us who go out and try to find out what's actually happening. Our usefulness, and that of anthropologists and other social scientists, is enormously increased because the system itself, including the press, doesn't bring information from the bottom to the top the way it does in a well-functioning democracy.

That is why we think that more democracy is needed; a more sophisticated democracy that allows people not only to elect their leaders, but to be able to provide the information that leaders need in order to provide adequate rules. In this connection, it is rather shocking to find the Biggs, Grindle, and Snodgrass paper suggesting that we drop the idea of the informal sector, when the only alternatives for structural change really outlined in that paper are regime change, authoritarian control, and political engineering; each is a form of manipulation of underdeveloped Latin Americans. Their classification of me as one of their "political engineers" manifests their misunderstanding of the difference between enlarging a group's influence within existing institutional boundaries and the very transformation of those boundaries.

And, in terms of the arguments for the expansion of the democratic process advanced by ILD, it also hurts enormously when the models for good market economics in developing countries are confined to South Korea, Taiwan, Hong Kong, and Singapore, which are evidently successful developing market economies. This ignores the countries that have become developed *with* the kinds of democratic institutions that ILD advocates. It also feeds into the arguments that our main enemies in Latin America, those who are usually in power, use against the ideas advanced by ILD: yes, market economics and the gospel truth are possible, but only under a dictatorship; democracy is not compatible with market economics in developing countries because—and then comes in the whole dependency theory—being on the periphery of a capitalist system, you actually are dependent. This argument is then reinforced by the contentions of Liberation Theology and neo-Marxism that because of our dependence, we must think about other types of priorities and other forms of development. This idea is much more popular than you may think. Nobody likes to think that the only way they can develop is under a slave driver. That is the reason why, in effect, market economics imposed by the Pinochets and the sort may last 15 years, 20 years, maybe 25 years, but they will be seriously challenged before they have eliminated underdevelopment. And the association of market economics with dictatorial government undermines the support which market economics might otherwise have.

Now, the paper by Biggs, Grindle, and Snodgrass seems to suggest that political change to authoritarian government may be more likely than democratic alternatives to provide the policy reforms, structural transformation, and economic growth which they advocate. What would the *Washington Post* or the *New York Times* or *Newsweek* think of such an idea? Such thinking is even less popular in Latin America. Furthermore, as suggested with reference to Pinochet, if there is not popular support for policy reforms, then those reforms are not likely to be sustained. And long-term development may be sacrificed at the altar of short-term growth.

Because we have recommended essentially the same policy reform measures as Biggs, Grindle, and Snodgrass, but in terms that enable the majority of Peruvians to recognize their personal interests in them and volunteer their support, we are more optimistic about the prospects for political democracy as our best means to both economic growth and the development of society than BGS appear to be. We have found that what informals believe in is amazingly complementary to the kinds of policy reforms which Biggs, Grindle, and Snodgrass advocate. But only when their belief in development and enterprise is expressed from their point of view—as they experience the negative effects of the bad policies which BGS would reform—do we find an attraction to those reforms in our country. This also applies to the major press of the United States whose reviews of *El Otro Sendero* have been remarkably unencumbered by the conventional resistance to scholarly formulations of the gospel truth. It seems that when the truth is expressed by informals, its audience is far more receptive.

In other words, the informal sector is very important in terms of selling these ideas, because informals provide the ideas with concrete, rather than abstract, justification. This enables these ideas to become viable in Latin America, because unless the majority of the population sees how it will benefit directly from the opportunities given to them and not simply through trickle-down effects from help provided a formal sector, it won't work out.

No matter how many structural adjustment clauses are put into all sorts of conventions that can be signed between A.I.D., the IMF, or the World Bank and countries like mine, they won't work unless they can be sold. You see, in my country the way government governs, in fact, is through a corporatist model. The president or the executive branch gets a request from abroad. He immediately brings—and this probably happens in Mexico as well—brings in the top entrepreneurial classes or the representatives of the guilds and the top trades union and says, all right, here's what they say we should do: We have over-valued exchange rates; we should do something about devaluing them. We have high levels of effective protection; we've got labor protection laws that are no good. What do you think we should do? And the reply, of course, will be negative.

But if you turn all of that around and we start addressing ourselves not to these people who represent in my country only 4.8 percent of the population which is unionized in the legal sector versus over 60 percent which is the informal sector, you can start getting different results. If you tell the informal sector that there's too much protection, that their spare parts are costing three times more than they should, then the potential for the policy reforms advanced by BGS are substantially magnified. For example, let's take the case of the bus and truck drivers. There are 300,000 of them in Peru. Including their families, that's one and a half million inhabitants; that's 8 percent of the economically active population. And you say that because of protection for domestic producers of their spare parts and their vehicles they are having to pay three times more for their inputs than they would with free trade. This population, more than balances off the fewer than 15,000 people who depend on car assembly production.

Reading this kind of news, President Garcia will have no doubt whether he's going to choose between 8 percent of the economically active population or the only one-tenth of one percent that is protected. But if the interests of the informal sector are not advanced in full public view, then Garcia will only be talking to the actually unionized members who are these 15,000, and they will set policy. So it's very important to bring in the informal sector.

Memories of the early days of the Institute, when we looked at a lot of theory and our inputs were mainly of an anthropological sort, came to mind as I read Janet Landa's very interesting paper. She is absolutely right that we have benefited from many influences. For example, legal efficiency is indeed a concept that contributed a lot to our work, and was gleaned from our reading of some of the literature on law and economics. Other possible influences may only be coincidences. It was only about a month and a half ago when I visited Washington University in St. Louis that the chairman of the Department of Economics informed me that we were really neoinstitutionalists. It's only now, by reading Janet Landa's paper, that I understand we must, in effect, be somewhat close to being neoinstitutionalists.

However, I would like to point out that we have done a lot of things that neoinstitutionalists have not done. For example, we found ways of measuring the efficiency of that law which neoinstitutionalists were not very helpful in pointing out. We've talked about rule making and how important rule making is in establishing the right kind of institutions, and the details of the rule making, how the rule making in developing countries in many cases differs from the ones in developed countries, which we did not find in any of the neoinstitutional literature.

We've talked about how you can actually prove the value of property even among poor people, how limited liability affects you, and how the lack of torts makes the private sector politically unviable in our countries, because nationalizations are not unpopular. Don't forget, for example, that when the banking sector or what remained of the private banking sector started being nationalized by President Garcia, it was a very popular move, like most of Velasquo's moves. And the reason for that is that the private sector is very unpopular in our countries because it has a lot of negative externalities which are not corrected because there is no good torts law in my country. I think of the total civil code, which as my colleague here, Mr. Bustamante can tell us, has maybe over 3,000 pages, there are barely two pages on torts law. So naturally, unless you correct the torts system you cannot have a private sector which functions well and of which most people will approve. We have not seen this issue addressed in the neoinstitutional literature. So although I'm glad it is being pointed out that we have other influences and that we have done some good reading, I don't think we are neoinstitutionalists all the way and a simple carbon copy of any U.S. university.

With respect to definitions of the informal sector, I would like to note that one of our main problems in trying to make the cause for poor people and the entrepreneurship of humble people in Peru and in Latin America was to make sure that we could distinguish their illegality, their form of not obeying the law, from the form of not obeying the laws that Mafias or drug traffickers manifest. The distinction is very important because traditionally in our country the formal sector has defended itself against the informal sector by insisting, at least in the case of the guilds, that the informals don't obey the law; that since the informal sector consists of non-law-abiding citizens, informality should be repressed, as it is in fact in most of the Third World.

By distinguishing the informal sector from the Mafia sector and not considering them as occupying different parts of a single continuum, as Landa does in her formulation of the shadow economy, we have contributed to new perceptions of informals—both self-perceptions and those of informals by participants in the formal sector. Informals are increasingly perceived as people who break the law, but who do so in order to achieve very legal and socially worthwhile objectives. Criminals, of course, are those who break the law to achieve objectives which are very antisocial. Our contribution to this distinction in Peru is reflected, I believe, in the responsiveness of informals to ILD activities. Had ILD not perceived their activities as the informals themselves perceive them, I do not think their mobilization in support of our endeavors could have possibly occurred.

In fact, in terms of either class or political activism, an informal does not at all feel identified with a drug trafficker; he's as much a victim as the rest of the formal economy. And whether it fits within traditional anthropological conceptualization or not, I think it's worthwhile at least for policy reasons to actually make a distinction between one side of the shadow economy and the other one, aside from calling it different names.

Next, I have, of course, been inspired for some time by the emergence of extralegal norms among Jews, Lebanese, Chinese, and other ethnic minorities, especially trading minorities in developing countries. However, there appear to be significant differences between the evolution of extralegal norms among more than 10 million Peruvians and those among very small groups of tightly knit ethnic minorities in developing countries which mitigate against the Peruvians being able to learn—again, in their own terms—from those experiences of others.

Of course, other literature has also been extremely useful for putting all of what we're doing in the context of good theory. But like neoinstitutionalism, like good neoconservative ideas, like good anthropology, there's a respectful distance to be maintained when you're getting close to reality. The gospel truth, no matter how loudly or frequently espoused, must relate to the experiences of the public if it is to be a public truth. Otherwise, they cannot mobilize for enabling the kinds of policy and structural changes which I join Biggs, Grindle, and Snodgrass in seeking.

6 *Jerry Jenkins*

Transforming the Formal Sector and Transcending Informality

The ultimate objective of this volume is to advance our understanding of the means by which the divisions within and between informal and formal economies can be ameliorated or eradicated. That objective dictates the nature of these concluding comments.

Though unanimity prevailed on very few issues during the course of the day-long proceedings represented in this book, there was agreement among seminar participants that undivided economies within countries improve resource allocation, accelerate economic growth, and increase equity.

Indeed, there appeared to be consensus that the eventual demise of the informal sector is desirable. However, this agreement was couched in another: the demise of a country's informal sector will only occur as a corollary of substantial change in its formal sector; the informal sector declining only as the formal sector incorporates the informals. Thus, there was no visible disagreement with the proposition that it is necessary for the formal sector to undergo qualitative change in order for it to incorporate the informal sector. Of course, this reported consensus must be qualified by the fact that here, as elsewhere, there was no uniform meaning of "informal sector" adopted by the seminar participants.

With respect to this meaning, Hernando de Soto, in his opening seminar presentation (appearing as Chapter 5 in this volume), more than in his prepared paper, clearly distanced himself from not only the effort to more precisely define the "informal sector," but from accepting either the necessity or value of doing so. This sharply contrasts with the orientations of Janet Landa as well as Tyler Biggs, Merilee Grindle, and Donald Snodgrass, whose emphasis on the (in)adequacy of definitions reflects their assignment of the burden for identification of informals to themselves and/or other analysts. Instead of accepting this analytic burden, de Soto seeks to design actions, like the Institute's draft laws, which enable informals to identify themselves.

De Soto appears to suspect that if the Institute for Liberty and Democracy were to adopt the analytic, rather than its interactive, burden, then the positive action required for attaining the structural transformation advocated by Biggs, Grindle, and Snodgrass might never be forthcoming. In short, de Soto accepts the burden of *eliciting* the self-identification of individuals within the informal sector by the institutional activities of ILD. Now, others might charge that this qualitatively different procedure for the identification of informals is self-fulfilling: if one *asserts* that those identifying themselves in response to an initiative are informals, then it is necessary to accept the assertion in order to accept the self-identifications as being those of informals. But de Soto does not contend that the analytic burden has been escaped, only that to accept it rather than the ILD alternative is likely to perpetuate the exclusion of most people (whatever they are called) from the rule-making process.

It is extremely rare for the division between proper analysis and desirable action, and the faith entailed by both, to be so vividly displayed. Its occurrence within the seminar, and the necessity of coming to grips with it, has (it seems) forced me to the conclusion that there is no choice between analysis and action that is available to those wishing to include the excluded. The choices, instead, are with respect to each and about their relationship.

Other choices within the seminar were comparatively easy. There was substantial agreement regarding the macroeconomic policies whose liberalization would be conducive to both accelerating economic growth and accomplishing the single-economy objective. Given fullest exposition in the paper by Biggs, Grindle, and Snodgrass, most of these reforms can be summarized as reducing governmental interventions with respect to *exposure to competition* of domestic firms, *prices* of goods and services, *interest rates* of both loans and deposits, and *currency values*, thereby allowing them to ensue from supply and demand of an open market.

Finally, it was uniformly recognized that wherever there are policy-induced distortions of the economy there are also beneficiaries who will be opposed to proposed reforms which would jeopardize their benefits. As Robert Bates observed and Hernando de Soto concurred, opponents of reform will include informal, as well as formal, sector elites. Thus, there is division within, and not merely between, the informal and formal sectors, and this increases the difficulty of mobilizing informals for supporting the changes required to permit their addition to a transformed formal sector.

Policy and Legal Reform: Same Destination — Different Directions

Though there was agreement regarding the policy changes required for accelerating economic growth and the incorporation of informal into formal sectors, there was disagreement regarding the requirements for accomplishing policy reforms of this magnitude. In effect, de Soto deems Biggs, Grindle, and Snodgrass to be begging the question with respect to policy reform. He shares their expectations of what will happen *if* policy reform occurs and concurs with the desirability of these reforms, but points to the closing section of their paper in concluding that they do not expect it and neither should anyone else.

De Soto *does not expect* liberalizing policy reforms—especially those which will be sustained into the indefinite future—*unless* the process of political decision making itself is liberalized. In short, he contends that opening up the political process is essential to the fulfillment of Biggs et al.'s aspirations for the liberalization and structural transformation of most economies.

In the section of their paper addressing "The Political Economy of Policy Change," Biggs, Grindle, and Snodgrass clearly recognize the basic impediments to liberalizing policy reforms which de Soto emphasizes:

> Past development policies have created interest groups which now fight for perpetuation of their favored positions. Equally significant is the creation of extensive bureaucratic agencies to promote development. In time, most develop clienteles, regulatory power and patronage-dispensing claims that they are loathe to see diminished through reform. Such interest groups are often able to block reforms aimed at undoing the harmful consequences of the very policies which created the interest groups.

Yet, as Jack Powelson observes in his lead commentary on their paper, they advise "reform advocates" to "be prepared to work to build consensus among decision-making elites" who they acknowledge are "loathe" to see their their patronage dispensing diminished through reform. This is something, Powelson concludes, "which simply cannot be done."

According to Biggs, Grindle, and Snodgrass, "Advocates of reform now call on governments to take the *same* leadership role in introducing policy reforms that they took 20, 30, 40 or 50 years ago" [emphasis added] in implementing the policies whose reform is promoted today. Judging from this seminar, however—comprising near-unanimity among attendees in support of the macroeconomic policy reforms advanced by Briggs, Grindle, and Snodgrass—most "advocates of reform" are calling on governments (and citizens) to take on quite *different* roles from those of years past in introducing policy reforms. Indeed, for the very patronage-dispensing reasons expressed above, most see such a difference of means as being essential to the structural transformation advanced by Biggs, Grindle, and Snodgrass.

The seminar also reflected considerable agreement regarding the need for changes in the substance and accessibility of formal law in order to incorporate informals and formals into a transformed single economy. This agreement is virtually necessitated by acceptance of ILD's (and de Soto's) criterion for the identification of informals (i.e., those pursuing legal ends without fulfulling all of the legal requirements for doing so).

Conclusions drawn from the papers and dialogue of Janet Landa and de Soto, in particular, are (1) to the extent that individuals in the informal sector provide facilitative law for themselves, they are likely to be its most economically successful members, and (2) to the extent that a country's government provides such law, informal economies will be less attractive to individuals, and the formal, relative to informal, sector will grow.

However, John Grayzel suggested that one society's "facilitative" law might be another's device for exploitation by extant elites. He warned that the prospects for incorporating informals into a new formal sector might be diminished by mere "strengthening" or modernization of extant formal law. Observing that the written law in most developing countries constitutes a barrier between the formal and informal sectors (whose participants interact in accordance with their respective rules-in-practice), he recommended the incorporation of elements of informal (usually traditional) law into new formal law as a means of avoiding this outcome.

De Soto indicates that the provision of generally accessible formal law, including its incorporation of informal rules, is most likely to occur where there are more fundamental changes in the very process of law making. The production of arbitrary rules, and, over time, an increasingly elaborate and incoherent body of law, are among his indictments of the structure of mercantile decision making. Rather than law not being provided by this structure, too much is generated—to the point that rather than enabling the reductions in uncertainty and risk that are associated with investment and economic growth, it creates additional uncertainty. Thus, while being inaccessible to informals and raising barriers to their entry into the formal sector, legal incoherence also raises the transaction costs of those already in the formal sector. The greater this burden, the greater the likelihood of individuals exiting from the formal into the informal economy.

Hence, as with liberalizing policy reforms, de Soto does not expect facilitative law to be generally accessible to a population *unless* that population is generally incorporated in the rule-making process. Thus, he might deem Landa, regarding the production of facilitative law, quite as much as Biggs, Grindle, and Snodgrass with respect to the attainment of policy reforms, to be begging the question of what must be done in order for the production of such law to be reasonably *expected.*

On the other hand, from Landa's perspective, she might view de Soto as begging the answer, if not the question. This is most evident in her pointed questioning of de Soto's characterization of the extralegal norms within the informal sector as being "eminently democratic" and spawning "a nondiscriminatory market economy." Landa's detailed exposition of the association between such "private law" and its providers' discrimination towards others within the informal sectors of several countries accounts for her inquiry.

At the very least, Landa suggests that Peru's informal sector might be an exception to a more general rule. That is, her theory explains that such discrimination on the part of groups, and their development of law-for-themselves within the informal sector is to be expected wherever formal law, on balance, does not facilitate individual activities in pursuit of economic gain. Drawing upon Landa's previous research, N. Vijay Jagannathan concludes that:

> In an analogous manner many of the poor in developing countries today are often able to use group conventions to appropriate economic benefits. Customary groupings like castes, tribes, or

> kinship groups are utilized productively, to generate wealth through restriction-seeking activities.[1]

Landa, however, might not accept Jagannathan's characterization of the "formal informals'" activities as "restriction-seeking." Her explanation of discriminatory, or exclusionary, consequences within the informal sector does not require *intent* to exclude by those whose actions restrict, in fact, the participation of others while expanding their own.

Instead, the discrimination that she observes is a consequence of *benefit*-seeking activities that have negative exclusionary consequences only to the extent that the general society fails to provide the public good of facilitative law which entrepreneurs in developed economies take for granted. Two of these benefits—not generally available to informals, but clearly provided among that subset of the informal sector which she terms the "shadow economy"—are insurance and credit.

Furthermore, Landa's documentation of the extension of credit among the most economically successful members of the informal sector demonstrates, as concluded in her paper, that extant measures of the size of the informal sector *necessarily* underestimate its magnitude. Perhaps it is not coincidental to the difference between Landa and de Soto regarding discrimination within the informal sector that de Soto relies upon conventional measures of the size of the informal sector; these assume that the sector is comprised of cash-only transactions.[2]

The differences between Landa and de Soto regarding discrimination within the informal sector and its apparent corollaries—the extent to which the size of the sector is underestimated by conventional measures due to their exclusion of credit transactions among informals—should not detract, however, from their shared conclusion. Indeed, their conclusion is reinforced by those differences. To the extent that Landa's expectations of discriminatory divisions within the informal sector are further verified by observation, the arguments of both her and de Soto for expanding the applicability of formal facilitative law are accentuated in importance. And to the extent that the structure of formal decision making is mercantile, the importance of de Soto's emphasis on changing the rule-making process is compounded.

In contrast with these emphases, Biggs, Grindle, and Snodgrass do not address the issue of legal transformation. This is consistent with their consideration of "the status of the firm in relation to law and regulation" as being no less, but no more, than one of many characteristics which cause problems (because they may be found to occur together or separately) when bundled together in definitions of the informal sector. However, de Soto, whom they cite in this regard, does not exemplify the problem because of the single (and, hence, unbundled) criterion for informality which ILD employs.

Nonetheless, Biggs, Grindle, and Snodgrass's nonadoption of the legality criterion is, of course, consistent with their view that development is better served by addressing "low productivity employment" instead of the "informal sector," and may account for their relative disregard of the legal transformation issue addressed by others. These positions also may explain their emphasis on the attainment of "consensus among the decision-making elite" rather than the broadening of its base pursuant to realization of liberalizing policy reforms; "elite broadening" would require changes in the rule-making process, whereas "elite consensus" would not.

Empowerment, not Entrapment

Seminar participants generally appeared to appreciate the risk of informal sector assistance raised by Biggs, Grindle, and Snodgrass: given the many things to which policymakers and practitioners refer in the name of the "informal sector," there is a tendency, when seeking to assist it or its constituents, to simply target the smallest of enterprises, thereby sponsoring a "small firm growth trap" which complements the "missing middle" (the dearth of middle-sized firms between twin peaks of very large and very small employers observed in most LDCs). This danger is compounded, of course, by those conceptions of the informal sector which exclude all but the smallest enterprises, and is further exacerbated by assessments like the following:

> Perhaps the distinguishing feature between the informal sector unit and the small enterprise is their orientation; whereas the former is motivated *primarily* by employment creation, the latter is concerned *primarily* with profit maximation.[3]

By this conception, the most successful "informal sector" endeavors identified by Landa or de Soto might simply be excluded from that sector. Given such a conception, assistance to the "informal sector" also would exclude assistance to those firms with the greatest potential for the employment of others—the "progressive" firms which are most likely to grow and occupy a now "missing middle"—the very firms for which Biggs, Grindle, and Snodgrass deem assistance to be most warranted.

A conception of the informal sector that excludes enterprises "concerned *primarily* with profit maximization" might necessarily require that those employing the conception address their attention and assistance to a very slight subset of the poor—the non-upwardly mobile poor or the poor who only want to improve the conditions of their lives a little bit. It is suggested that such a conception would incorporate so small a minority of the poor as to yield perhaps the best reason for abandoning the concept of "informal sector" that has been provided to date—that the costs of identifying members of this tiny population would too greatly exceed the benefits of finding them.

Of course, all of the authors represented in this volume provide assessments of the capacities and behavior of the poor, or once-poor, that are fundamentally incompatible with such a distinction between "the informal sector" and "the small enterprise." Thus, rather than the "informal sector" whose population size is shrunk-by-conception, de Soto, and especially Landa, delineate informal sectors whose populations are burgeoning by observation. It is hoped that observers who deny informal sector status to some enterprises because their characteristics are not commonly observed among the total informal sector population will become increasingly aware of all the implications of their distinctions and, in turn, make these explicit for others.

Unfortunately, the irony yielded by Landa's observations—the greater the increase of credit transactions over time, the greater should be the (conventionally) measured decline of the productivity, if not population, of the informal sector—is more than ironic. Clearly, new measures of the magnitude of production within informal sectors must be devised in order to escape an impending quandary: informal sectors whose increasing populations will be belied by "measured" declines of their production.[4] Reliance upon the conventional cash-based measures will increasingly yield a picture of "entrapment" (less production by more people) to the extent that "empowerment" (the private provision of credit, insurance and other public goods) is in fact being realized.[5] In short, without new measures, *real* increases in empowerment will yield *measured* increases in entrapment. Such a state of affairs is obviously worse than failing to count; it yields numbers that lie.

Concern for avoiding the entrapment of informals is among the three most apparent reasons for de Soto's very positive response to the economic policy reforms advocated by Biggs, Grindle, and Snodgrass. First, he too would be opposed to assistance to an informal sector which excluded its most successful members. Second, assistance would likely increase informals' acceptance of the status quo and decrease the appeal of ILD's promotion of their political participation for the purpose of being incorporated in the rule-making process of a new formal sector. Third, in neither his paper nor during the course of the seminar did de Soto call for financial assistance to informal enterprises.

Instead, de Soto's policy reform recommendations appear to largely parallel those of Biggs, Grindle, and Snodgrass, principally calling for policies which do not necessarily favor the already favored. Thus, for example, he urges market-determined interest rates for all potential borrowers rather than government-determined below-market rates at which all loanable funds are absorbed by those with the greatest collateral, and which thereby exclude most informals.

Because a significant aspect of ILD's overall program entails participating with informals in mobilizing for changes in formal sector political decision making, the Institute's mission would be jeopardized by entrapment of informals in sustained low productivity employment. De Soto clearly believes that empowerment of informals, by their incorporation in the political decision-making process of a new formal sector, is essential to avoiding their entrapment.

Indeed, de Soto suggests that the empowerment of informals is necessary, as well, for the *formal* sector to avoid its own entrapment in a zero-sum, no-growth economy.[6] And an important part of ILD's activities—its continuous publicization of the entrepreneurial accomplishments of informals—is intended, it appears, to change perceptions of informals by both themselves and those within the formal sector. To the extent that these perceptions are thereby positively altered, ILD's success will not be fully measured by its most visible, short-term accomplishments. And a reading of Robert Bates' commentary on Janet Landa's paper suggests that nothing more should be anticipated.

Bates presents a lucid exposition of the reasons why the incorporation of informals in formal sector transformation is unlikely to be achieved, regardless of how skillfully ILD and others campaign to that end. He cogently identifies the disincentives for individuals in both the formal and informal sectors, and most especially their respective elites, to organize in sufficient numbers for liberalization of policies and the decision-making process. Key to understanding this assessment with respect to informal sector participants is the reactive nature of the informal sector. In Bates' words:

> It is likely that many of the most profitable activities in this reactive economy would cease being profitable were markets liberalized. In economies characterized by government interventions, there are shortages which are created by government restrictions. Many of the profits in the informal economy are earned by circumventing these shortages and by allocating resources whose supply has been rendered scarce as a consequence of government policies. These profits would be threatened by liberalizing reforms.

And, in the prevailing formal sector status quo, wherein government interventions have impeded the formation of a private market, and enabled officials to "target their favors [and] transform the market into a political organization":

> No single politician [in a competitive political environment] could afford unilaterally to abjure the prevailing pattern of market intervention. To do so unilaterally would be to undercut the basis of one's political organization; it would leave the advantage with any political opponent who might promise to continue the policies which nurture the economic fortunes of political cronies and economic hangers on. The advantage thus lies with the old guard, i.e., whoever persists in protectionist ways while others advocated market reformism. Unless all politicians simultaneously switch to a reformist platform, then no single politician will be able to do so.

And these results are anticipated even where each official prefers a shift to private markets.

In addition to these obstacles to both the liberalization of macroeconomic policies and formal sector transformation, Nancy Truitt observed that even some "successes" might not be. Unless assistance to the informal sector focuses on and changes the way in which rules are made, she suggested that no more might result from such assistance than enabling some informals to gain special legislation for themselves. These "strengthened" informals would then have a newly vested interest in maintaining the extant decision-making structure in addition to the legislation which specially benefits them.

But Truitt's observation raises an alternative possibility: that campaigns for changing the way in which rules are made, rather than for particular material outcomes of the decision-making process, might succeed in evading the disincentives posed by Bates for altering status quo benefits. In essentially single-economy countries, this would not seem to be a viable alternative, but where a substantial informal sector exists that is largely excluded from the rule-making process, that exclusion, itself, can be perceived by informals as the principle reason why they are not doing better than they are.

Thus, an issue which would be too general to inspire collective action in a single-economy country might be exactly the issue in terms of which most informals could identify with one another and collectively pursue because each participant could envision this action yielding greater individual benefits tomorrow than exist today. And, from de Soto's description of the collective action occurring within and among various associations of informals, there is not only acquired experience among informals in so acting, but, perhaps, extant institutional elements that could be incorporated in the transformation of the formal sector. Perhaps this is what Frances Johnson had in mind during the seminar when urging the strengthening of the "informal *political* sector."

This alternative and others are most likely to be successfully advanced during the course of electoral campaigns in elections which are genuinely contested. And a political party and its officials cannot be expected (for the very reasons articulated by Bates) to implement such fundamental change of the decision-making process *unless* a campaign has been waged on the issue and an election won with the promise of such transformation. Then, but only then, with that kind of mandate, can an elected government be expected to broaden the rule-making process and incorporate informals in the new formal sector.

Short of this, democratically elected governments in multi-economy countries are likely to continue to sacrifice the legitimacy which they might otherwise command. As long as this is the case, "democracy" is apt to be more associated with the growth of informal sectors than with the enhanced equity of opportunity among individuals which enables people and countries to fully realize their potentials. It seems apparent that a shorter path must be broader; that the path to realizing human potentials will be made less treacherous and distant by its broadening. Conversely, exclusions of those who wish to make the journey portends a destination never reached.

Notes and References

1. Jerry Jenkins, "Informal Economies: Emerging From Underground"

1. *Ford Foundation Letter* 16, no. 2 (April 1984).

2. George Aryee, "The Informal Manufacturing Sector in Kumasi," in S. V. Sethuraman, ed., *The Urban Informal Sector in Developing Countries: Employment, Poverty and Environment* (Geneva: International Labour Office, 1981), pp. 91–2.

3. See the several studies in the volume cited in the previous note.

4. See Carl Liedholm and Donald Mead, *Small Scale Industries in Developing Countries: Empirical Evidence and Policy Implications*, MSU International Development Paper No. 9 (East Lansing: Department of Agricultural Economics, Michigan State University, 1987), p. 18.

5. *Ibid.*, p. 1. The quoted phrase is attributed to David Morawetz, "Employment Implications of Industrialization in Developing Countries: A Survey," *Economic Journal* (September 1974).

6. *Ibid.*, p. 20.

7. *Ibid.*, p. 20, fn. 7.

8. On the quandary and its resolution, see, among others: Albert Berry, "Open Unemployment as a Social Problem in Urban Colombia: Myth and Reality," *Economic Development and Cultural Change* 23, no. 2 (January 1975), pp. 276–291; Peter Gregory, "Employment, Unemployment, and Underemployment in Latin America," *Statistical Bulletin of the OAS* 2, no. 4 (October-December

1980), pp. 1–20; and Albert Berry and R. H. Sabot, "Unemployment and Economic Development," *Economic Development and Cultural Change* 33, no. 1 (October 1984), pp. 99–116.

9. Erik Thorbecke, "Impact of Stabilization and Structural Adjustment Measures and Reforms on Agriculture and Equity," in Elliot Berg, ed., *Policy Reform and Equity: Extending the Benefits of Development* (San Francisco: ICS Press, 1988), p. 61.

10. See, for example, Barry Molefsky, "America's Underground Economy," in Vito Tanzi, ed., *The Underground Economy in the United States and Abroad* (Lexington, MA: D. C. Heath and Company, 1982), especially p. 64.

11. Roberto Junguito and Carlos Caballero, "Illegal Trade Transactions and the Underground Economy of Colombia," in *Ibid.*, pp. 285–313.

12. The finding that 42.6% of Lima's housing is informal (reported in Hernando de Soto's paper in this volume) is lower than that reported for Italy. A comparison of statistics recorded by two different government agencies enabling a conservative estimate of housing construction that was more than double the official total is provided in, Daniela Del Boca and Francesco Forte, "Recent Empirical Surveys and Theoretical Interpretations of the Parallel Economy in Italy," in *Ibid.*, pp. 181–197, esp. 192–5.

13. From the February 15, 1988, press conference remarks of Alejandro Portes, director of a project assessing informal economies in more than 20 cities of five continents. The project was begun in 1981, and the book resulting from the endeavor should be of interest to readers of the present volume. Edited by three of its 19 essayists, Alejandro Portes, Manuel Castells, and Lauren A. Benton, *The Informal Economy: Studies in Advanced and Less Developed Countries*, is scheduled for publication in 1988 by Johns Hopkins University Press.

14. Keith Hart, "Informal Income Opportunities and Urban Employment in Ghana," *Journal of Modern African Studies* 11, no. 1 (March 1973), pp. 61–89.

15. S. V. Sethuraman, "The Informal Sector in Indonesia: Policies and Prospects," *International Labour Review* 24, no. 6 (November-December 1985), p. 719.

16. International Labour Office, Jobs and Skills Programme for Africa (JASPA), "Employment Incomes and Production in the Informal Sector in The Gambia," Report submitted to the Government of The Gambia by a JASPA technical assistance mission (Addis Ababa, July 1980), p. 4.

17. William J. House, "Nairobi's Informal Sector: Dynamic Entrepreneurs or Surplus Labor?" *Economic Development and Cultural Change* 32, no. 2 (January 1984), p. 279.

18. *Ibid.*, p. 281.

19. Lyn Squire, *Employment Policy in Developing Countries: A Survey of Issues and Evidence* (New York: Oxford University Press, 1981), p. 81.

20. A useful review of the literature on market failures is provided by Charles Wolf, Jr., "A Theory of Non-Market Failures," *Public Interest* 55 (Spring 1979), pp. 114–33.

21. Kenneth Arrow, "Political and Economic Evaluation of Social Effects and Externalities," in Julius Margolis, ed., *The Analysis of Public Output* (New York: Universities-National Bureau of Economic Research; distributed by Columbia University Press, 1970), p. 2.

22. P. T. Bauer, *Equality, the Third World, and Economic Delusion* (Cambridge, MA: Harvard University Press, 1981), pp. 103–4.

23. This may be reflected in the fact that only 25% of the informal sector entrepreneurs interviewed by Fowler in Freetown, Sierra Leone, expressed a preference for formal sector wage employment (interestingly, the percentage of those who had completed secondary education expressing this preference was somewhat less—22%). And, with respect to movement from the formal into the informal sector, "in Hong Kong, 60 per cent of the informal sector entrepreneurs were formerly employed in the formal sector; and in Lome (Togo), 64 per cent." See D. A. Fowler, "The Informal Sector in Freetown: Opportunities for Self-Employment," in S. V. Sethuraman, *The Urban Informal Sector in Developing Countries* (Geneva: International Labour Office, 1981), p. 67, and S. V. Sethuraman, "The Urban Informal Sector and Development Policy," in the same place, p. 44.

24. Claudia Rosett, "How Peru Got a Free Market Without Really Trying," *The Wall Street Journal* (January 27, 1984), p. 31.

2. Hernando de Soto, "Constraints on People: The Origins of Underground Economies and Limits to Their Growth"

1. This section is excerpted and adapted from "Internal Structural Reforms in Peru: a Promising Road out of the Debt Crisis," by Robert Litan, Luis Morales-Bayro, and Jorge Fernandez-Baca, published in *Journal of Economic Growth* 1, no. 2 (1986), pp. 28–35.

3. Janet T. Landa, "Underground Economies: Generic or *Sui Generis*?"

1. The concept of "shadow" economy used in this paper differs from the concept coined by Ivan Illich. His term refers to "transactions which are not in the monetized sector and yet do not exist in pre-industrial society. . . . With the rise of the shadow economy I observe the appearance of a kind of toil which is not rewarded by wages, and yet contributes nothing to the household's independence from the market. In fact, this new kind of activity, for which the shadow work of the housewife in her new nonsubsistent domestic sphere is one prime example, is a necesary condition for the family wage earner to exist. Thus shadow work, which is as recent a phenomenon as modern wage labor, might be even

more fundamental than the latter for the continued existence of a commodity-intensive society" (1981, pp. 1–2).

The shadow economy that I refer to in this paper emphasizes a different phenomenon, i.e., the capacity of a group to create its own law and order: "private orderings" in the terminology of Galanter (1983).

2. For a fascinating study of numerous ethnic/cultural/religious groups engaged in cross-cultural trade in world history, see Curtin (1984).

3. The interviews with rubber dealers and members of the Chinese community were conducted in Singapore and West Malaysia by myself and two research assistants, between June 1969 and January 1970.

4. See Omohundro (1983) and Yengoyan (1983) in Lim and Gosling, eds. (1983).

5. For a comprehensive discussion of transaction costs economics, and the New Institutional Economics, see Williamson (1975, ch. 1; 1985, ch.1). Also see North (1986) and Langlois (1986, ch.1) for a discussion of the New Institutional Economics.

6. For a discussion of the Austrian approach to the evolution of institutions, see Langlois (1986, ch. 1).

7. For a discussion of various aspects of Public Choice theory, see Mueller (1979).

8. The term "reflexive theory of the emergence of norms" was invented on the spot by Mark Granovetter while discussing with me my theory of the emergence of norms embedded in the EHMG (personal communication, February 1987).

9. My theory of middleman success differs from the work of so-called radical political economists, e.g., Darity and Williams (1985), in that I use an efficiency thesis and not a Marxian exploitation thesis to explain racial discrimination and ethnic monopoly of certain occupational roles, e.g., merchant roles. My theory of middleman success is closer to the work of sociologist Bonacich, but differs from her work in explicitly emphasizing the transaction cost implications of ethnic homogeneity of the middleman group.

10. I am indebted to Elinor Ostrom for emphasizing to me the necessity to view social institutions as emergent phenomena and the need to engage in several levels of analysis.

11. In recent years, economic historians have increasingly recognized the importance of laws and institutions for promoting economic growth of the Western World. See North (1982), and Rosenberg and Birdzell, Jr. (1986).

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4. Tyler Biggs, Merilee S. Grindle, and Donald R. Snodgrass, "The Informal Sector, Policy Reform, and Structural Transformation"

1. Some "informal" activities in developing countries exhibit high productivity (e.g., self-employed professionals), but these generally represent a small proportion of the total. Many others provide returns higher than the wages that are paid to unskilled laborers. Some may even show average productivity levels that compare favorably to those of many "formal" economic activities. But all have low productivity relative to the potential levels attainable through economic development. It is above all in this last sense that we use the term "low productivity" in this paper.

2. Based on Chenery and Syrquin (1975), Chenery, Robinson, and Syrquin (1986) and Syrquin (1987).

3. A problem arises because the economically active nonagricultural population at the beginning of the period (1950) was twice as large as the labor force in industry. Growth at the same percentage rate (4.1 percent) from these different bases meant that absolute increases in modern industrial employment fell considerably below absolute annual increments in the economically active nonagricultural population. For the modern industrial sector to keep pace in absolute terms with the rising economically active population, it would have had to grow at a rate about one-third faster (approximately 6.3 percent).

4. The statistics in the preceding section indicated that productivity and wages in urban industry and tertiary employment did not decline generally in the 1950–80 period. But this indication that "soft" employment is not increasing does not mean that a transformation is taking place which makes workers better off.

5. Specific suggestions for the Philippines are made in Biggs et al. 1987.

6. In view of recent publicity given to the role of small and medium enterprises in employment creation and other developed countries, it is worth citing data on this point published by the OECD (OECD, 1985: 65). In seven OECD member countries for which data on employment by enterprise size in the entire private sector were available, the employment shares of large enterprises (500 employees or more) ranged from 27 percent in Japan to 59 percent in Sweden. Medium (100–499 employees) and large enterprises together accounted for more than half those employed in the private sector in all countries except Japan, where the figure was 44 percent. In the manufacturing sector the predominance of medium and large enterprises was even greater. Large enterprises accounted for 33 percent (Japan) to 71 percent (the United States) of total employment in the 15 countries for which data were available. Medium and large enterprises together made up 60 percent or more of manufacturing sector employment in all these developed countries except Japan, where the figure was 53 percent. In the service sector, large enterprises generally represented 25–30 percent of total employment.

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5. Hernando de Soto, "The Informal Path to Transformation"

1. This chapter is drawn from the transcribed oral presentation of the author's reflections on the other two principal papers prepared for this volume. It has been edited by Jerry Jenkins.

6. Jerry Jenkins, "Transforming the Informal Sector and Transcending Informality"

1. N. Vijay Jagannathan, *Informal Markets in Developing Countries* (New York: Oxford University Press, 1987), p. 27. Due to its inaccessibility prior to the October 1987 seminar, the contents of Jagannathan's book are not reflected in the principal papers and citations of the present volume. However, it is recommended here as a "must read" book for those who will be engaging in additional study of informal sectors.

2. In de Soto's case, this under estimation is provided by Robert Litan, Luis Morales-Bayro, and Jorge Fernandez-Baca, "Internal Structural Reforms in Peru: A Promising Road out of the Debt Crisis," *Journal of Economic Growth*, 1, no. 2 (1986), pp. 28–35.

3. S. V. Sethuraman, "Concepts, Methodology and Scope," in S. V. Sethuraman, ed., *The Urban Informal Sector in Developing Countries: Employment, Poverty and Environment* (Geneva: International Labour Office, 1981), p. 17.

4. This anticipated quandary parallels that posed by increases in urban migration in spite of increases in urban underemployment, a quandary overcome by "discovery" of the "informal sector," as discussed on p. 3 of this volume.

5. As an initial approximation of the magnitude of measurement error attibutable to the cash-based criterion, it is proposed that there is a positive association (probably curvilinear) between the proportion of an informal sector's total transactions that do not require cash at point-of-sale and the extent to which the sector is characterized by extra-legal norms—and, that each of these variables thus have a positive, curvilinear, relationship with both the magnitude of wealth created within the informal sector *and* the magnitude of under estimation of total production within the sector that are yielded by cash-criteria measurements.

An additional, albeit more speculative, proposition is that the emergence of the foregoing characteristics is more likely in multiethnic developing countries than in others. Though this proposition is suggested by Landa's research, it is doubtful that she would subscribe to it due to other factors not incorporated in her work to date—such as the heightened uncertainty and political instability, even to the point of ethnic genocide—that are also associated with multiethnic societies. In such extreme cases, it is difficult to envision the realization of "elite broadening," or incorporation of informals in the formal rule-making process, in lieu of transformation of formal government in accordance with one or another of the models of federalist systems. For a prototype of such vision, in the form of poignant, yet practical, recommendations, see Francis Kendall and Leon Louw, *After Apartheid: The Solution for South Africa* (San Francisco: ICS Press, 1987).

Recognition of the oxymoron of "empowered entrapment," and the preceding footnote's expectation that it will appear to be increasingly prevalent in the absence of new measures of informal sector production, is in no way intended to deny that cash-based transactions are the prevailing norm in informal sectors and are likely to continue to be so for many years to come. Hence, we should continue to expect the less capital-intensive trade and commerce activities, rather than those of industrial production, to predominate in the informal sectors of most countries. Furthermore, the trade of goods whose quality and quantity are most readily and easily ascertained by purchasers (rice, rather than rubber, for example), are unlikely to be associated with the emergence of private law and the groups who provide it (EHMGs, or otherwise) because there is less benefit to be derived from its provision relative to the costs of doing so. That transaction costs (and, hence, trust required) are less in the rice than rubber markets is cogently discussed by Samuel L. Popkin, "Public Choice and Rural Development—Free Riders, Lemons, and Institutional Design," in Clifford S. Russell and Norman K. Nicholson, *Public Choice and Rural Development* (Washington, D.C.: Resources for the Future, 1981), pp. 43–80, esp. 71–74.

6. To fully address this possibility, a book much larger than the present volume would be required. This expanded treatise would include assessments of a "white collar underground" whose members' behavior retards the growth of indigenous formal sector economies. This footnote is offered in order to convey important dimensions of our topic which can be only fleetingly addressed within the present volume.

Increasingly, human capital flight (to domestic underground economies) is being appreciated, more or less explicitly, as a corollary of monetary capital flight (to other countries). See, for example, the new chapter appearing in the revised fifth edition of Robert Z. Aliber, *The International Money Game* (New York: Basic Books, 1987), entitled, "Underground Economies and the Bureaucratic Imperative," pp. 228–235.

Elsewhere, Robert Cumby and Richard Levich—in "Definitions and Magnitudes: On the Definition and Magnitude of Recent Capital Flight," in Donald R. Lessard and John Williamson, eds., *Capital Flight and Third World Debt* (Washington, D.C.: Institute for International Economics, 1987), pp. 27–67—have even more explicitly linked the migration of human and monetary capital:

> In the human capital literature, it was argued that, given the mobility of factors, human capital would migrate if it did not receive a competitive market wage. Now the analogy is that financial transactions and financial capital will migrate also if domestic depositors and investors are not offered financial services with competitive risks and returns. In this environment, capital flight ought to be viewed as a symptom of underlying economic problems, rather than as the source of the problem (pp. 50–1).

Of course, Cumby and Levich are posing an analogy between two *inter*national phenomena. Embellishment of this analogy, by introduction of the informal sector *within* countries into our conceptual-analytic frameworks, suggests that extant measures of the respective magnitudes of both "capital flight" and the "informal sector" may systematically yield under estimates of the size of either. This parallels the experience of potential emigrants, whose own assessment of "another country" to which emigration is possible *includes* the informal sector *within* the countries of current residence. The "introduction" and "embellishment" of the preceding are already occurring; most explicitly, to my knowledge, by Marcos Victorica (of the Buenos Aires-based Institute for Contemporary Studies)—as represented from an oral presentation in John D. Sullivan, ed., *Building Constituencies for Economic Change: Report on the International Conference on the Informal Sector* (Washington, D.C.: Center for International Private Enterprise, 1987)—in addressing:

> what we call the monetary emigrants or informals. Informality is how people who don't want to leave the country emigrate. They don't emigrate physically; they just do it monetarily. . . . [and] capital flight is caused by the same factors as the informal economy. If the causes are the same, then the remedy is also the same. The problems of the foreign debt might be solved with the same kind of measures that would integrate the formal and informal economies (p. 9).

Contributors

Robert H. Bates is Henry R. Luce Professor of Democracy, Liberty, and the Market Economy at Duke University. His *Markets and States in Tropical Africa: The Political Basis of Agricultural Policies* is widely recognized as a landmark inquiry into the political economy of development. He recently edited *Toward a Political Economy of Development: A Rationalist Perspective* (1988).

Tyler S. Biggs is an economist at the Harvard Institute for International Development, currently studying industrial organization in developing nations; previous research includes agricultural policy and urban/rural development. He has served as West African representative for the Ford Foundation, as a staff member of the Rockefeller Foundation, and as a consultant for the World Bank and the Agency for International Development.

Merilee S. Grindle is a political scientist at the Harvard Institute for International Development, where she is a specialist in the policy process in developing countries and focuses on agricultural and rural policy development and implementation. She has consulted with the World Bank, the Agency for International Development, and the InterAmerican Foundation. Her most recent book is *Search for Rural Development* (1988).

Jerry Jenkins, Sequoia Institute's President, previously taught political economy and international relations at the University of Georgia. His early development of uncertainty-reduction theory and its explanations of violent conflict account for his research focus on "enabling institutions," which reduce uncertainty by maximizing both the freedom of individuals and their positive interdependencies.

Janet T. Landa is Associate Professor of Economics at York University in Ontario. She has been a National Fellow at the Hoover Institution and a Visiting Fellow at the Workshop in Political Theory and Policy Analysis, Indiana University. Her publications have centered on the emergence among individuals of institutions for the private provision of contract law and other public goods in lieu of their supply by formal governments.

James L. Payne is currently Visiting Scholar at the Social Philosophy and Policy Center, Bowling Green State University. He previously taught political science at Yale, Wesleyan, Johns Hopkins, and Texas A & M. His books have analyzed the Peruvian labor movement, Colombian politics, and political leadership in the Dominican Republic. His most recent work is a just-published study of worldwide military trends, *Why Nations Arm*.

John P. Powelson is Professor of Economics at the University of Colorado. He has taught at the University of Pittsburgh and Johns Hopkins, worked on the staff of the International Monetary Fund, consulted with the Inter-American Development Bank, and served as an economic advisor to the governments of Kenya and Bolivia. His most recent book is *The Story of Land: A World History of Land Tenure and Agrarian Reform* (1988).

Donald R. Snodgrass, an economist at the Harvard Institute for International Development, is a specialist on Southeast Asia and coordinator of the Institute's Employment and Enterprise Policy Analysis Project. He has worked on the staff of the Yale Economic Growth Center, the Ford Foundation, and the Agency for International Development. He is presently co-authoring a book about the economic development of Southeast Asia.

Hernando de Soto is President of the Institute for Liberty and Democracy (ILD) in Lima, Peru, where he also serves as director of several businesses and is a member of the United Nations Committee for Development Planning. He has worked as an economist with the General Agreement on Tariffs and Trade, as managing director of engineering and financial corporations in Europe, and as a Director of Peru's Central Reserve Bank.

Participants

Robert Adams, AFR/TR, A.I.D.
David Alverson, ANE/TR/ARD, A.I.D.
William Barron, AFR/TR, A.I.D.
Robert Bates, Department of Political Science, Duke University
Juan Belt, LAC/DP, A.I.D.
L.E. Birdzell, Author
Katherine Blakeslee, PPC/PDPR, A.I.D.
Maura Brackett, LAC/DR, A.I.D.
Dennis Brennan, DAA/S&T, A.I.D.
Charles Buchanan, AFR/PRE, A.I.D.
Alberto Bustamante, Instituto Libertad y Democracia
David Cahn, ANE/PD/PE, A.I.D.
Stuart Callison, PPC/PDPR, A.I.D.
A. Chickering, Institute for Contemporary Studies
L. Gray Cowan, PPC/PDPR, A.I.D.
Thomas Dailey, PPC/PDPR/RPD, A.I.D.
Kay Davies, PPC/WID, A.I.D.
Jean-Jacques Deschamps, DAI
Lee Edwards, Center for International Relations
Shirley Erves, AFR/DP, A.I.D.
Kathy Fauster, USIA
Sandra Frydman, S&T/RD, A.I.D.
Michael Farbman, S&T/RD/ESE, A.I.D.
Mark Gallagher, ANE/PD, A.I.D.
Rick Garland, LAC/SR, A.I.D.
Susan Goldmark, DAI
John Grayzel, S&T/RD, A.I.D.
Helen Gunther, ANE/TR/ARD, A.I.D.
Jerry Jenkins, Sequoia Institute
Frances Johnson, AFR/PRE, A.I.D.
Margaret Jones, ARA/ECP, A.I.D.
Donald Kennedy, PPC/WID, A.I.D.
Margaret Kromhout, LAC/PS, A.I.D.
Janet Landa, York University, Ontario, Canada
John Lewis, AFR/SWA, A.I.D.
Manuel Mari, Inter-American Development Bank
Donald McClelland, PPC/PDPR/RPD, A.I.D.
Frank Method, PPC/PDPR/SP, A.I.D.

PREVIOUS PAGE BLANK

Tridib Mukherjee, ANE/TR/ARD, A.I.D.
Tom Nicastro, RPE/PD, A.I.D.
Amy Nolan, PRE/H, A.I.D.
Haven North, PPC/CDIE, A.I.D.
Thomas O'Keefe, PPC/PD, A.I.D.
Jude Pansini, PPC/WID, A.I.D.
Mario Pastore, Department of Economics, Ithaca College
James Payne, Social Philosophy and Policy Center, Bowling Green State University
Jim Pinkelman, A.I.D.
John Powelson, University of Colorado
Curt Reintsma, AFR/PD/SWAP, A.I.D.
Christopher J. Ruhm, Department of Economics, Boston University
Christopher Russell, AID/PRE, A.I.D.
Keith Sherper, AFR/TR, A.I.D.
Donald Snodgrass, Harvard Institute for International Development
Helen Soos, AFR/PRE, A.I.D.
Pablo Spiller, Department of Economics, University of Illinois
Steven Sposato, AFR/DP, A.I.D.
Carol Steele, AFR/CCWA, A.I.D.
John Sullivan, Center for International Private Enterprise
Howard Sumka, PRE/H, A.I.D.
Nancy Truitt, Americas Society, Inc.
Vinie Vallet, ARA/EDP, A.I.D.
Paul Vitale, PRE/H, A.I.D.
Howard Wallack, Center for International Private Enterprise
Warren Weinstein, AA/PPC/SA, A.I.D.
Neal Zank, PPC/PDPR, RPD, A.I.D.
Hernando de Soto, Instituto Libertad y Democracia
Bob Young, A.I.D./S&T/RD/EED

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