

CONSTRAINTS ON PEOPLE: THE ORIGINS OF UNDERGROUND
ECONOMIES AND LIMITS TO THEIR GROWTH

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I. SUMMARY

The Instituto Libertad y Democracia (ILD) has come up with striking new conclusions about the causes of Latin American underdevelopment and how to resolve it through its study of the informal sector.¹ The publication of the book setting forth its 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 just the five countries in which it has been launched 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 informality. It is forthcoming in Argentina for the Southern Cone countries, and in Brazil where it has been translated into Portuguese. Translation into English is completed; translation into German and French is underway.

1

The 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.

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 it has been launched the ILD has been contacted by leaders of all of the major political parties, interested 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% of its GDP.

Informality is a symptom of institutional disfunction because it indicates that much of the law has lost its legitimacy. Obviously, then, the key question is why informality exists. 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, as the ILD demonstrates with facts and figures, 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 non-discriminatory 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 and European mercantilism of the XV to the XIX centuries, which was attacked by both Adam Smith and Karl Marx. This mercantilism decayed or was violently overthrown to be 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 legislating. For example, in Peru an average of 99% 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 wide spread 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 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 a major breakthrough in development thought. It has identified the key

problems, laid out the direction for reform, demonstrated popular support and had an impact on legislation. To move from here to the implementation of real reform, a long term program is required.

II. RESULTS OF THE ILD'S ACTIVITIES

A. 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% of the 1984 gross domestic product was produced informally and that 61.2% 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% of the housing in Lima was informal; nevertheless, our work demonstrated that informal housing actually makes up 42.6% of all housing in the capital, sheltering 47% 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% 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 91,435 street vendors in the capital representing 42.2% of labor involved in commerce, distributing approximately 60% of the food in the city and earning an income almost 40% 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% of the mass transportation fleet and 80% 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%. 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% of the production of garments and furniture and some 35% of textile production. The ILD's estimates indicate that informal industries compose 52% of industrial production establishments, employ 34.2% of industrial workers and generate 18% of the value added in the whole sector.

B. 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.

1. 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 4 years and 8 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, 7 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 3 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, 9 years and 8 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 3 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 6 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 sectoral activities, but also to factor markets. One dramatic example is access to capital. 85% 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% 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 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 fifty small, formal firms of 1-14 employees each. These entrepreneurs, it was established, maintain only 23.3% of their gross profits. The other 76.7% goes to the government. Of this, only 22.9% 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% of gross income in the form of bribes to government officials.

2. 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.

a. 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 or 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, investment increased 9 times once people had title to their land.

b. 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.

c. 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.

d. 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.

C. 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% of the Peruvian rules and regulations while Congress approved only 1%.

Thus, on average, 99% 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 5 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 XV and XIX 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.

D. 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% 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 launched 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 constituency. 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.

III. 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 anti-democratic

and anti-entrepreneurial 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.

A. 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 anti-entrepreneurial 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 ILO 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.

B. 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 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% and organized labor, 4.8%. 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 coopting 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 Part 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.

C. 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 UN 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 leftist added two innovations. Whereas Lenin had pictured the "center" as rent by "inter-imperialist" 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 coopting local Marxists and/or of appealing directly to the Marxists' ideological constituency.

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 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.

D. 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 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 anti-liberal 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 biases 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.

E. 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 what so ever. 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 given great importance to stability, believing it crucial to economic growth and, generally, to western interests. Because in many Latin America 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 -- anti-democratic and anti-market -- and proving that it is the poor -- and majority -- who support and practice democracy and accesible 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.

F. 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% 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 importantly, 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 benefitting 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.

2
G. Increasing Economic Growth

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.

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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, Vol. 1, No. 2 (Second Quarter, 1986), pp. 28-35.

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 ILO 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 channelled 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.

VI. CONCLUSION

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. 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;
- * public education to mobilize support for change.